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THE 1983 ECONOMIC REPORT OF THE PRESIDENT

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BEFORE THE

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CONGRESS OF THE UNITED STATES

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JANUARY 26, 27, AND 31, AND FEBRUARY 2, 1983

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THE 1983 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 26, 1983

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 6226, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Symms, Mattingly, Proxmire, and Sarbanes; and Representatives Hamilton, Hawkins, Obey, Scheuer, Wylie, Holt, Lungren, and Snowe.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; Richard F. Kaufman, assistant director-general counsel; and Louis C. Krauthoff II, Mark R. Policinski, and David A. Smith, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator Jepsen. The Chair would wish to welcome Secretary Regan and thank you for being here today. The Joint Eonomic Committee is always honored by your appearance before us.

In the last few months, there has been a steady stream of news stories about the deficits in future years. There have also been many stories about the President's ability to control his own administration.

Basically, the President was told by his critics that it was time to "put up or shut up." Last night I think he gave them an earful.

How long have we heard about the "uncontrollable" spending programs that could never, ever be cut? This President has put an end to this myth by telling the truth: the only reason they are uncontrollable is because Congress refused to cut them. The President has demanded action in reducing these programs and Congress should oblige.

How long have the nonpartisan experts told us that something must be done about cost-of-living adjustments in our Federal pension plans? This President decided not to look the other way. Acting on the bipartisan suggestions of the Social Security Commission, this President has suggested a 180-day freeze for all Federal cost-of-living adjustments. This President will not ignore the necessary though painful decisions that must be made to reduce the deficit.

How long have we been told this President would not cut defense spending? Well, he wants it cut $55 billion. And, I believe he is flexible and he will go for even larger cuts provided they are rational and they do not interfere with the basic security of this Nation and they do not reduce the level of defense we need to keep the peace. A strong defense will enable us to go to the negotiating tables and negotiate effectively. That is continually what this President has stated. And, by the way, it's also what the Constitution of the United States mandates the Congress to do, one of the few things, and that is to provide for the national security.

How long have we been told that this President would have to scrap his third year of the tax cut or indexing of the tax system? We see now that this President will stand by the taxpayer.

And because the third year tax cut and indexing have been kept, if Congress reduces spending along the lines of the President's suggestion, we will have no need for the so-called standby taxes in 1986.

The program that the President put forth last night is a comprehensive plan to end the economic slump and guide the recovery. But maybe the most important aspect of the President's speech was his call for the cooperation of both political parties in helping solve our problems.

We here on the Joint Economic Committee know how valuable bipartisan cooperation can be in trying to find solutions to our economic problems. In these tough times, the country will be better served if we spend less time trying to make a point and more time trying to make a contribution.

Mr. Secretary, we meet today with every major forecaster telling us that the recovery is now underway. And many forecasters are predicting that the recovery will show surprising strength. Housing and auto sales continue their rather dramatic improvement. Inventories have been reduced, a guarantee that production increases will be translated into new employment.

Durable goods orders rose a record 12 percent in December providing grounds for an increase in overall output. Inflation, incredibly, is less than 4 percent. Savings in the economy have increased and interest rates, though still high, have fallen.

In conclusion, Mr. Secretary, all these signs are good but still we have not reached our goal of noninflationary economic growth. I hope that as the budget debate unfolds we will see an improving economy help guide Congress. It would be a disaster if, just as the recovery begins, Congress takes steps that will cut the recovery short.

With those opening remarks, I would now defer and yield to the distinguished vice chairman of the Joint Economic Committee, Congressman Hamilton.

Representative **Hamilton**. Thank you very much, Senator. I have no remarks. I just want to welcome the Secretary to the Joint Economic Committee this morning. I look forward to your testimony. There are many questions for you, and I think it would be good to get to those as soon as possible.

Senator **Jepsen**. Are there any other members who desire to make opening remarks? [No response.]

If not, I have opening statements provided by Senator Abdnor and Representative Wylie, and I will insert them into the record at this point, without objection.

[The opening statements of Senator Abdnor and Representative Wylie follow:]

OPENING STATEMENT OF SENATOR ABDNOR

I cannot let this opportunity pass, Mr. Secretary, without calling your attention once again—as I did a year ago—to the extremely depressed economic condition of U.S. agriculture. The Department of Agriculture has projected farm net income in 1983 at $15 to $19 billion. As a result, 1983 will mark the fourth consecutive year of declining and record-low net income for U.S. farmers. Perhaps equally distressing is a recent report out of USDA that during the last 3 years the value of farm proprietors' equity in constant 1972 dollars has fallen over $100 billion, a 21-percent decline.

Traditionally, in making loan decisions farm lenders have been able to look beyond the income problems of farmers to their equity-wealth position. That position has eroded tremendously during the last 3 years and, given the Department of Agriculture's 1983 farm net income projection, we can fully expect farm equity to plummet even further in 1983. Many farmers may find it very difficult to secure even short-term credit sufficiently to put in this year's crop. Now that is a particularly ugly method of supply control.

I contend, Mr. Secretary, from both an income and wealth perspective, no sector of our economy is suffering more from this recession, and therefore, has the most to benefit from an economic recovery, than the farming community. I must say that while domestic economic recovery is necessary for the return of farm prosperity, it will not be sufficient. The product of one out of every three acres harvested in this country is sold in foreign markets. Only when there is world economic recovery can American farmers expect to earn an adequate and fair return on their effort and investments.

These are challenges which must certainly burden you tremendously, Mr. Secretary. This Congress must share that burden and work responsibly with the administration to devise and implement desperately needed solutions.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Secretary Regan, we all heard the President's state of the Union address last night. I, for one, was pleased and impressed with what the President said. I think the President deserves our support as he puts up more sail.

We are all worried about unemployment and deficits. But there are also some good things happening in the economy—the decline in inflation and interest rates and the improvement in productivity. While December showed a dip, I think housing and autos could pave the way for significant improvements in the economy in 1983. I trust you will discuss some of the good news to help counterbalance the bombardment of bad news we've had the past year.

The question on all of our minds is, is this the quarter of turnaround in the economy? We heard a lot of hopeful promises on this from time to time last year, but is this really it?

On the tax front, I hope we don't renege on the tax cuts of 1981. I hope you will shed some light on the administration's thinking regarding tax reform. How much strength is there behind the administration's consideration of sweeping tax changes—consumption taxes, flat taxes, or what have you, that we have been reading about in the papers lately?

Mr. Secretary, we welcome you to this hearing and look forward to your testimony.

Senator JEPSEN. OK. Secretary Regan, you may proceed. Welcome to the committee.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman, members of the committee.

It's a pleasure to meet with you today to discuss the current state of the economy and the outlook for the future. Two years ago the incoming Reagan administration inherited a very difficult economic situation. As the President stated in the state of the Union message, "The problems we inherited were far worse than most inside and out of government had expected. The recession was deeper than most inside and out of government had predicted."

However, the worst is over. Economic indicators such as housing starts, inventories, and real income show the economy is poised for recovery. Inflation is down from 12.4 percent for 1980 to 3.9 percent for 1982. Interest rates are down from peak levels of 21.5 percent on the prime to 11 perecnt currently and the stock market last year reached new peaks. Alongside these favorable developments, there is the distressing fact of high levels of unemployment.

The task now is to encourage the renewal of economic growth to reduce unemployment and provide productive job opportunities in the private sector. In so doing we must not repeat the errors of the past and return to an inflationary economy.

The current domestic situation is complicated by the existence of large Federal budget deficits and the threat of even larger ones in years to come. These budget deficits will have to be reduced since their persistence would inevitably lead to very adverse consequences for the U.S. economy and its financial markets.

Many of the economic difficulties we face at home are also faced by countries abroad. The entire international economy is experiencing a severe slowdown, complicated by the special debt-servicing problems of a number of countries. My prepared statement today deals primarily with the U.S. domestic economy, but it is obvious that the domestic and international situations are closely linked. The clear need in both cases is to encourage expansion rather than undergo further contraction.

It is important to recognize that current difficulties are the culmination of a long period of deteriorating economic performance in this country. The U.S. economy was in deep trouble long before the current recession began. It follows that our policies must aim at lasting longrun solutions. There are no quick cures.

Inflation has led to a roughly parallel rise in key interest rates. As shown in chart III of any prepared statement, interest rates and inflation, the 3-month Treasury bill rate followed the rate of inflation very closely over most of the period. Thus, inflation appears to have been a major factor in the increase in the bill rate since the early 1960's.

Rising rates of inflation after the mid-1960's did not lead to more rapid economic growth for any sustained period of time. Quite the contrary. Inflation and its inevitable consequence of higher interest rates finally choked off real growth altogether.

APPROACH OF THE REAGAN ADMINISTRATION

The administration's primary economic goal upon coming to office was a fundamental restructuring of the economy, including: Bringing inflation under control; shifting the composition of activity away from Government spending toward more productive endeavors in the private sector; and providing an environment which would reward innovation, work effort, saving and investment, and in which free-market forces could operate effectively.

Over the past 2 years we have seen evidence that the program is working. The fundamental elements of recovery are now largely in place. Inflation has been brought under control. Interest rates are coming down, as shown in the second chart. That's chart VI among those charts that we furnished to you. Real wage growth is being restored. In addition, there have been other improvements—notably in productivity growth and saving behavior—which mark a shift away from the problems that contributed to sluggish economic performance in recent years.

Within this framework of very significant achievements, there remains the fact that the economy has been in recession and unemployment is high. The unemployment rate of 10.8 percent in December is, of course, a matter of great concern. The President has indicated in his state of the Union message that he will be submitting special legislation to help deal with this problem.

THE CURRENT STATE OF THE ECONOMY

The economy now stands poised for recovery. In fact, the recovery may well already be underway at this moment. It has been much longer in coming than we had expected or, for that matter, than had been expected by nearly all forecasters.

The delay occurred primarily because of the persistence of high interest rates and because of developments in the international sphere. On the international front, the economies of our leading trading partners continued to weaken. Weakness among all the industrialized nations was self-reinforcing. Furthermore, the financial difficulties of some of the newly industrializing nations had adverse impacts on economic activity here. These forces, combined with a general hesitancy on the part of the consumer, led to another round of inventory cutting in the second half of 1982 and delayed the expected turnaround of the economy.

SIGNALS OF AN ECONOMIC UPTURN

There are clear signals that the economy is turning around now and that the recession will soon be behind us. To summarize these signals:

The index of leading indicators has risen for 7 out of the last 8 months.

Housing is in the midst of a rapid recovery.

Businesses trimmed inventories sharply in the final quarter of last year. Historically, a cleanout of inventories typically has been followed by a shift back to higher rates of production.

Retail sales have begun to firm.

Total industrial production stabilized in December and appears poised to turn upward.

THE TYPICAL RECOVERY

We would all hope for a vigorous recovery, not unlike those which occurred in the past. The typical postwar recovery path is shown in the next chart, which is chart IX in the ones furnished to you. Excluded from it are the two atypical recoveries—the first of which included the Korean war buildup and the second which got underway late in 1980 but was short-lived. The five recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from the real gross national product trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

Senator **JEPSEN**. Excuse me, Mr. Secretary, if I may.

Secretary **REGAN**. Yes.

Senator **JEPSEN**. Is it possible to put a line in there on the Reagan recovery?

Secretary **REGAN**. Yes. That would be much farther below there. It would be on this path [indicating]. We're projecting, as I'll state later in my testimony, 3.1 percent real growth in 1983, fourth quarter over fourth quarter and 4 percent for 1984. So if you would take that line, that would bring us out somewhere in here [indicating].

The contributions of gross national product components to real growth during the typical recovery are shown on chart X of my prepared statement. I think this is the most interesting of the charts. It indicates that the initial thrust for expansion comes first from a resurgence in homebuilding, such as is currently underway; a swing in inventory investment from decumulation in the later stages of recession to accumulation; and a major contribution from consumer spending, with purchases of consumer durables registering particularly large increases.

If you'll notice, in this particular chart there is no need for an increase in Federal purchases. Federal purchases in the first eight quarters of recovery have been negative on average. State and local purchases only contribute a small amount.

A vigorous recovery of the type outlined would be most welcome. It would certainly help ease the Nation's budgetary problems. If, for example, real gross national product were to grow only 0.5 percent more than in our current forecast in both 1983 and 1984, the deficit would decline to $90 billion in 1988 instead of the $117 billion that we estimate in the budget. If real gross national product growth reached the high rates obtained during the early 1960's—that is, 1.3 percent higher growth in each of the next 6 years—we could balance the budget by 1988. However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern:

Our overall trade balance is likely to register further marked deterioration in the coming year.

Real interest rates may persist at high levels though far below those prevailing a year ago.

The economy is in the process of undergoing marked structural change. Some of our industries may not quickly regain the vitality they experienced in the 1950's and 1960's. The shift of resources to emerging industries will take time.

Most fundamentally, we are not yet fully out of the inflationary woods, and we cannot afford to direct monetary and fiscal policy toward excessively rapid economic expansion.

For these reasons, the administration will be forecasting fairly modest real growth at a 3-percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much, though certainly we would welcome a stronger recovery. Growth is expected to pick up modestly to the 4 percent range in 1984 and the years beyond.

POLICIES FOR THE RECOVERY

In setting policy for the remainder of the 1980's, we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither.

MONETARY POLICY

Achievement of a gradual steady growth in the money supply to a noninflationary pace has been, and continues to be, one of the major goals of the administration's economic program. The Federal Reserve's efforts to achieve that goal have been complicated by a number of factors, such as far-reaching institutional changes in the banking and thrift industries. Nevertheless, the Fed has generally succeeded in its efforts albeit in a somewhat erratic fashion.

The Federal Reserve's efforts to slow money growth have, however, been accompanied by some volatile short-run swings. Growth in the narrowest monetary aggregate, M_1, was actually negative on a 13-week basis by midsummer of last year, and then soared to the double-digit range by the end of the year. This recent acceleration has caused some observers to conclude that the fight against inflation and inflationary money growth has been abandoned. That is not true. Both the administration and the Federal Reserve remain committed to the longrun goal of providing money growth at a noninflationary pace consistent with a steady and sustainable expansion of economic activity.

Monetary policy faced a difficult and uncertain situation during much of last year. Rapid institutional change in the form of new money market instruments blurred the boundaries between the various aggregates and made the achievement of any target rates of growth unusually difficult. There is also some indication that the recession may have led to an increased demand for liquidity and precautionary balances. In 1982, growth in monetary velocity—the rate in which money is used—turned negative for the first time in nearly three decades. Under the unusual economic and institutional circumstances of 1982, some temporary offset in the form of above-target rates of monetary growth was probably desirable.

FISCAL POLICY

The objectives of our fiscal policy upon coming to office 2 years ago were twofold. First, we believed and still believe it was imperative to correct the disincentives to economic performance that had been built into the tax structure over the years. Second, it was equally imperative to reverse the seemingly inexorable growth of Federal spending, thereby freeing resources for use in the private sector.

The tax reforms that were put in place were designed primarily to restore an adequate rate of return on investment in plant and equipment and to put a halt to the steady upcreep of marginal tax rates on labor and savings income. The investment incentives were necessary to bring long-depressed U.S. investment rates and productivity growth rates up to acceptable standards. For individuals, the tax cuts were needed to protect incentives and purchasing power. For the average taxpayer, they will only result in an actual dollar tax cut in 1983 after allowance for the effects of bracket creep and higher social security taxes. And the 1983 cut will be needed to offset scheduled increases in social security taxes.

It is of utmost importance that we do not revert to old policies by repealing the indexation to become effective in 1985 and relying on inflation to provide hidden, unlegislated increases in tax rates. What is needed now is not a reversal of previous reforms in the tax structure, but additional reforms to provide for even further reductions in disincentives. We will be taking a careful look at the structure of the entire tax system over the coming year.

We were relatively successful in working with the Congress to achieve our goals of tax reform, but we were less successful in the area of outlay control. This, along with much weaker economic activity than expected, has left us facing the prospect of large deficits even as the economy recovers.

This administration has determined that deficits of the magnitudes bandied about in the press lately will not come to pass. We will take whatever measures are necessary to narrow the deficit to acceptable levels, preferably by reducing outlays. However, if we are not successful in reducing outlays sufficiently, and large deficits continue to loom in the outyears, we are prepared to request additional revenue raising measures to be effective in those years. In the event taxes are needed, this administration will do its best to structure the Tax Code in a way that minimizes disincentives for productive effort.

POLICIES FOR A CHANGING ECONOMIC STRUCTURE

Not only must we maintain steady monetary and fiscal policies directed at reinvigorating the private sector, but we must carry through with policies of reducing the regularly burden on private industry. Noteworthy successes have been achieved in this area, particularly in the deregulation of the financial system. For the first time in the postwar period, small investors can count on being able to obtain market rates of return on their savings from banks and thrift institutions.

Further, we recognize that our economy and those of the other industrialized nations are undergoing a period of restructuring. This is an era of rapid technological change, and comparative advantage in the production of many goods and services is shifting from the already developed to the newly developing nations. Those nations which expend all their energies shoring up declining industries and resisting change will find themselves with industrial bases that are obsolete and with declining relative standards of living. Their more foresighted and innovative neighbors will be moving forward and capturing newly opening markets.

Government can ease the painful process of structural change within the economy. The President has announced a program that relies heavily on the market mechanism to deal with structural unemployment that stems from problems in both labor and product markets. This program will emphasize training, retraining and relocation, and job-search assistance for workers facing the lack or loss of jobs even after an economic recovery. Other proposals will be designed to reduce the barriers to youth employment.

Finally, in setting the proper course of policy for the 1980's, we must work closely with the other industrialized and newly industrializing nations of the world. International negotiations are nearing completion on measures to assure that the International Monetary Fund has adequate resources to help countries experiencing difficulties implement sound policies of economic adjustment. The participation of the United States in an increase in IMF resources is an essential complement to domestic measures to achieve sustainable economic growth and represents a valuable investment in defense of the economic interests of the American farmer, laborer, businessman, and consumer. Legislation providing for the U.S. share of the increase in IMF resources will be submitted in the near future and I urge prompt approval by the Congress.

In final analysis, I am confident that if President Reagan's proposals to the Congress are adopted, we will find ourselves safely on the road to noninflationary economic recovery. Only through cooperation and determination can we insure prosperity for all Americans.

[The prepared statement of Secretary Regan follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss the current state of the economy and the outlook for the future. Two years ago the incoming Reagan Administration inherited a very difficult economic situation. Real growth had declined steadily in the late 1970's and was negative by 1980. Inflation had soared to double digit levels. The ensuing two years have seen serious economic recession as a result of the inflation/tax spiral. On the bright side, inflation is down from 12.4 percent for 1980 to 3.9 for 1982.

However, the worst is over in the sense that signs such as housing, inventories, and real income show the economy is poised for recovery. Interest rates are down from peak levels of 21-1/2 percent on the prime to 11 percent currently and the stock market last year made new peaks. Alongside these favorable developments, there is the distressing fact of high levels of unemployment.

The task now is to encourage the renewal of economic growth to reduce unemployment and provide productive job opportunities in the private sector. But in so doing we must not repeat the errors of the past and return to an inflationary economy. That's been our past experience and it only leads to an even more severe adjustment at some time in the future. The correct course of action is to persevere with our policies that are designed to promote long-run economic growth while keeping inflation securely under control.

The current domestic situation is complicated by the existence of large federal budget deficits and the threat of even larger ones in the future. These budget deficits will have to be reduced since their persistence would inevitably lead to very adverse consequences for the U.S. economy and its financial markets.

Many of the economic difficulties we face at home are also faced by countries abroad. The entire international economy is experiencing a severe slowdown, complicated by the special debt-servicing problems of a number of countries. My prepared statement today deals primarily with the U.S. domestic economy, but it is obvious that the domestic and international situations are closely linked. The clear need in both cases is to encourage expansion rather than undergo further contraction.

The Background of Current Difficulties

There would be no point to a lengthy review of past developments. It is important to recognize, however, that current difficulties are the culmination of a long period of deteriorating economic performance in this country. The U.S. economy was in deep trouble long before the current recession began. It follows that our policies must aim at lasting long-run solutions. There are no quick cures.

The origin of most of our current difficulties was the failure to control inflation after the mid-1960's. Once underway, the inflationary process was fueled by excessive rates of monetary expansion and developed a momentum of its own. There have been intense periods of inflation before in this country, but only temporarily at, or near, wartime peaks. The Great Inflation of the 1960's and 1970's is without parallel in previous U.S. experience. As shown in Chart I, each cyclical peak and trough in the rate of inflation following the mid-1960's was at successively higher levels. The basic rate of inflation was finally ratchetted to double digit levels. Only now and at great cost has the upward trend of inflation been interrupted.

Rising rates of inflation after the mid-1960's did not lead to more rapid economic growth for any sustained period of time. Quite the contrary. Inflation and its inevitable consequence of higher interest rates finally choked off real growth altogether. As shown in Chart II, real growth averaged about 4 percent annually in the decades of the 1950's and 1960's, and slowed to a little over 3 percent in the 1970's. Indeed, by the late 1970's, real growth was nonexistent. And, since 1979 there have been two recessions and real growth has turned negative. Over most of this period of time while growth was declining, the rate of inflation moved upward more or less steadily.

Rising rates of inflation after the mid-1960's led to a roughly parallel rise in key interest rates. As shown in Chart III, the 3-month Treasury bill rate followed the rate of inflation very closely over most of the period. Thus, inflation appears to have been a major factor in the increase in the bill rate since the early 1960's.

Proposals to force down interest rates through monetary expansion fail to recognize that over long periods of time the absolute level of nominal interest rates is determined by an underlying real rate of interest plus a premium equal to the expected rate of inflation. Sustained periods of monetary expansion drive up the rate of inflation and pull up interest rates. The chart also shows very clearly the extent to which interest rates have risen above the inflation rate in the last few years of unusually violent swings in money growth. The resulting increase in real interest rates is due to what might be termed a wider risk or volatility premium -- in addition to the inevitable inflation premium.

The combination of inflation and rising interest rates was extremely harmful for the economy. The continuation of inflation over long periods of time encouraged the assumption of heavy debt burdens by individual and corporate borrowers in the belief that a new era of permanent inflation had commenced. Those debt burdens have become extremely heavy as the period of inflation has drawn to an end. Inflation also exerted a depressing effect on corporate profitability both because of inadequate financial provision for the replacement of real capital and because of the unremitting pressure of wage demands to keep pace with increases in the cost of living and rising tax rates.

The combined effect of rising interest rates and downward pressure on profit margins is shown in Chart IV. The share of profits in national income has fallen more or less steadily since the mid-1960's while the interest share has risen. Both of these trends have accelerated in recent years. Some of the recent rise in net interest may simply reflect the deregulation of financial markets -- a healthy development. But, the long period of inflation offered unhealthy incentives for borrowing and reduced the share of profits in national income.

By late 1980, the U.S. economic and financial situation had reached a very difficult stage. Critics would do well to recall the state of affairs which this Administration inherited, as I stated earlier.

Approach of the Reagan Administration

The Administration's primary economic goal upon coming to office was to reverse the situation. In our view that required a fundamental restructuring of the economy, including:

- bringing inflation under control;
- shifting the composition of activity away from government spending and toward the private sector into more productive endeavors;

- providing an environment which would reward innovation, work effort, saving and investment, and in which free-market forces could operate effectively.

Within a month of coming into office, President Reagan put before Congress a four-point program designed to reverse the steadily deteriorating performance of the past decade and a half. That program consisted of:

- spending restraint;

- tax reductions;

- far-reaching regulatory improvements;

- gradual, steady reduction in the rate of monetary growth to a pace consistent with noninflationary expansion of the economy.

While we did not get our full package through Congress in the exact form we had asked for, our success in achieving quick approval of the major elements of the program was unprecedented. This support doubtless reflected widespread recognition that restoring vitality to the economy would require broadscale revamping of fiscal and monetary policies.

Over the past two years we have seen evidence that the program is working. We have made very significant gains on the inflation front and we are now witnessing a reduction in interest rates, both of which are prerequisites for a resumption of solid economic growth.

- In the twelve months ending in December consumer prices rose only 3.9 percent -- far below the back-to-back double-digit increases of 13.3 percent and 12.4 percent in 1979 and 1980 and the smallest rise since price controls artificially depressed the statistic in 1972. The broadest measure of inflation, the GNP deflator, has come down by more than half since 1980 to an increase of only 4.6 percent during 1982. These statistics mark an achievement of primary importance in restoring economic vitality. The inflationary spiral has been reversed, thereby conquering the major economic problem of the past decade and a half.

- The reduction in inflationary pressures has also been visible in wages. But because prices had risen less, there was good news on wages for the employed people of this country. The average hourly earnings index increased only 5.9 percent in the twelve months ending in December, the smallest rise since 1967. Nonetheless, after four years in which workers had seen the steady erosion of the purchasing power of their earnings, 1982 was the first time since 1977 in which a real wage gain was posted. (Chart V shows the recent record on earnings and price growth.)

- It took somewhat longer than hoped for interest rates to come down. Rates remained sticky through the spring of last year (Chart VI), stalling the widely anticipated recovery. However, as markets became aware that the progress on inflation was not transitory, interest rates began to drop. The prime fell from 21-1/2 percent in September 1981 to 11 percent currently -- a dramatic reduction. The three-month Treasury bill rate has also fallen by about 500 basis points from the end of June to about 8 percent currently and is down by more than half from its peak. Yields on Aaa corporate bonds are now about 11-3/4 percent, a drop of a little over 300 basis points since last June.

- The decline in interest rates was certainly at least in part responsible for triggering the phenomenal stock market rally that took place this fall. Stock prices are now running more than 35 percent above their August lows, contributing signficantly to household wealth.

We have strong evidence that the fundamental elements of recovery are now largely in place. Inflation has been brought under control. Interest rates are coming down. Real wage growth is being restored. In addition, there have been other improvements -- notably in productivity growth and saving behavior -- which mark a shift away from the problems that contributed to sluggish economic performance in recent years.

- During the latest recession the falloff in productivity has been less than normal, apparently reflecting vigorous efforts by business to reduce costs. Productivity in the total business sector turned positive in the second quarter of last year and scored a strong 4.2 percent annual rate of advance in the third quarter. Gains in productivity are usually greatest in the early stages of recovery so we can look forward to further progress as real growth resumes. Since high productivity reduces costs per unit of output, this will help ensure that inflationary pressures are not reignited when the recovery gets underway.

- The personal saving rate has also registered improvement since the first portions of the Administration's tax rate reductions and savings incentives were put into effect in October 1981. In the five quarters since then, the personal saving rate has averaged 6.7 percent, up from the 5.9 percent rate that prevailed from 1977 through 1980.

Within this framework of very significant achievements, there remains the fact that the economy has been in recession and unemployment is high.

- The unemployment rate of 10.8 percent in December is, of course, a matter of great concern. It is important to remember, however, that in December the share of the working-age population with jobs was 56.5 percent -- 1-1/2 percentage point above the 1975 low and close to the peaks reached in the 1960's. (See Chart VII.)

The Current State of the Economy

The economy now stands poised for recovery. In fact, the recovery may well already be underway at this moment. It is always some time after the fact before the actual month of turnaround can be pinpointed.

The recovery has been much longer in coming than we had expected, or, for that matter, than expected by nearly all forecasters. Last year at this time we were projecting that improvement in the economy would begin to emerge in the spring and that growth during the four quarters of 1982 would be 3.0 percent. This was almost exactly the consensus of private forecasters, as contained in Blue Chip Economic Indicators of January 1982, which projected real growth of 3.1 percent during the year. Last summer the economy appeared to be in the process of turning around, and we, along with the private forecasting community, projected recovery in the second half of the year. The delayed coming of the recovery has been a major disappointment.

The recovery was delayed primarily because of the persistence of high interest rates and because of developments in the international sphere. Interest rates remained intractably high into the summer. Rates in general tend to be slow to change on the way down. Additionally this year, inflationary expectations failed to incorporate fully the rapidly proceeding process of disinflation. On the international front, the economies of our leading trading partners continued to weaken. Industrial production of OECD European countries dropped at an 8 percent annual rate between the first and third quarters of last year, and production in Japan was unchanged. Weakness among all the industrialized nations was self-reinforcing. Furthermore, the financial difficulties of some of the newly industrializing nations had adverse impacts on economic activity here. To cite but one example, our exports to Mexico were down in October and November by about 60 percent from a year earlier, or nearly $11 billion measured at an annual rate. Overall, the slide in total real net exports accounted for nearly one-half of the total decline in real GNP between the third quarter of 1981 and the final quarter of last year. These forces, combined with a general hesitancy on the part of the consumer, led to another round of inventory cutting in the second half of 1982 and delayed the expected turnaround of the economy.

Signals of an Economic Upturn

There are clear signals that the economy is turning around now and that the recession will soon be behind us. To summarize these signals:

- The index of leading indicators has risen for seven out of the last eight months.
- Housing is in the midst of a rapid recovery. New home starts jumped by 45 percent in the fourth quarter from a year earlier; and permits increased by 60 percent over the same span. As shown in Chart VIII, new home sales have risen 55 percent since the spring quarter of last year, and inventories of unsold homes have hit the lowest levels recorded in more than a decade.
- Business trimmed inventories sharply in the final quarter of last year -- a 6 percent annual rate for the nonfarm sector. Historically, a cleanout of inventories typically has been followed by a shift back to higher rates of production.
- Retail sales have begun to firm. Sales of the major nonautomotive discretionary components of consumer purchasing -- namely household durables and clothing -- rose at an impressive 11-1/2 percent annual rate in real terms in the final three months of last year. Automobile sales appear to be in the early stages of recovery, following a four-year period of decline. Auto production is slated to rise by 20 percent (not annualized) in the first quarter of this year from the prior quarter, and that increase could be even larger should sales continue to outpace currently announced production schedules.
- Total industrial production stabilized in December and appears poised to turn upward.

- Weekly initial claims for state unemployment insurance have been trending downward since mid-October. And even though employment continued to decline in December, decreases in recent months have slowed notably.

- Finally, declines in interest rates and the resurgence of stock prices since last summer are indicative of a vastly improved financial climate.

The Typical Recovery

We would all hope for a vigorous recovery, not unlike those which occurred in the past. The typical postwar recovery path is shown in Chart IX. Excluded from it are the two atypical recoveries -- the first of which included the Korean War buildup and the second which got underway late in 1980 but was short-lived. The five recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from the real GNP trough were within an extremely narrow range of 10.2 percent to 12.0 percent -- in the 5 to 6 percent annual rate range.

The contributions of GNP components to real growth during the typical recovery are shown in Chart X. Notably, that chart clearly indicates that stimulus from higher Federal spending is not a prerequisite for strong recovery. In fact, real Federal purchases declined on average during previous recoveries, and especially so during their early stages. Furthermore, improvement in our real balance of net exports also is not necessary for strong recovery, as it too has typically weakened during the early stages of recovery. Real capital spending typically contributed but little to the early stages of recovery, though picking up steam in the second year.

As the chart indicates, much of the initial thrust for expansion comes from:

- A resurgence in homebuilding activity, such as currently is underway.

- A swing in inventory investment from decumulation in the later stages of recession to accumulation. Decumulation proceeded rapidly in the fourth quarter of last year, apparently setting the stage for a swing upward in inventory investment over coming quarters.

- A major contribution from consumer spending, with purchases of consumer durables registering particularly large increases. Consumers recently have vastly improved their financial positions, and with the age of existing stocks of consumer durables, most importantly of autos, having increased substantially over the past several years, coming quarters should witness a rebound in consumer spending.

The Outlook for the Economy

A vigorous recovery of the type outlined would be most welcome. It would certainly help ease the Nation's budgetary problems. If, for example, real GNP growth was only 0.5 percent higher than our current forecast in 1983 and 1984, the deficit would decline to $90 billion in 1988 instead of the $117 billion estimated in the budget. If real GNP growth reached the high rates obtained during the early 1960's (1.3% higher growth in each of the next six years) we could balance the budget by 1988. However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern.

- Our overall trade balance is likely to register further marked deterioration in the coming year, reflecting the recent high value of the dollar and the serious problems of our trading partners.
- Real interest rates may persist at high levels though far below those prevailing a year ago.
- The economy is in the process of undergoing marked structural change. Some of our industries may not quickly regain the vitality they experienced in the 1950's and 1960's. The shift of resources to emerging industries will take time.
- The transition to a noninflationary environment is not an easy one. In particular, as inflation is winding down, businesses face uncertain returns on investment programs, as they will not know what prices they may be able to charge in the future. Only one thing is certain -- they will not be able to count on ever accelerating inflation to bail out faulty investment decisions.
- Most fundamentally, we are not yet fully out of the inflationary woods, and we cannot afford to direct monetary and fiscal policy toward excessively rapid economic expansion. Rather, we must set our sights on achieving a steady, stable, long-lived expansion, one in which inflation can be further reduced and the conditions for rapid growth of productivity and living standards can be fostered.

For these reasons, the Administration will be forecasting fairly modest real growth at a 3 percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much. Certainly we would welcome a strong recovery. Growth is expected to pick up modestly to the 4 percent range in 1984 and the years beyond.

If we are successful in making this difficult transition and move onto a sustainable, noninflationary growth path, then we can look forward to years of improved economic performance such as we enjoyed during the 1950's and in the early 1960's. Such a growth path can only be achieved by consistent application of the proper mix of policies. It will certainly require that we take immediate and strenuous efforts to reduce the budget deficits that loom ahead.

Policies for the Recovery

In setting policy for the remainder of the 1980's, we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither.

Sound policy for the remainder of the 1980's must build on the framework enunciated by the President two years ago. That program was designed to foster an economic climate in which the private sector could flourish. The problems facing us are even more severe than we envisaged two years ago, but we still believe the general course laid out then was the proper one.

Monetary Policy

Achievement of a gradual slowing of growth in the money supply to a steady and noninflationary pace has been, and continues to be, one of the major goals of the Administration's economic program. The Federal Reserve's efforts to achieve that goal have been complicated by a number of factors such as by far-reaching institutional changes in the banking and thrift industries. Nevertheless, the Fed has generally succeeded in its efforts albeit in a somewhat erratic fashion: in the four years ending in 1980, growth in the money supply (M1) from fourth quarter to fourth quarter averaged nearly 8 percent annually. In 1981, M1 growth slowed sharply to a 5 percent rate, and from the fourth quarter of 1981 to the third quarter of 1982 M1 grew at only a 5.3 percent annual rate.

The Federal Reserve's efforts to slow money growth have, however, been accompanied by some volatile short-run swings. Growth in the narrowest monetary aggregate, M1, was actually negative on a 13-week basis by mid-summer of last year, and then soared to the double-digit range by the end of the year. This recent acceleration has caused some observers to conclude that the fight against inflation and inflationary money growth has been abandoned. That is not true. Both the Administration and the Federal Reserve remain committed to the long-run goal of providing money growth at a noninflationary pace consistent with a steady and sustainable expansion of economic activity.

Monetary policy faced a difficult and uncertain situation during much of last year. Rapid institutional change in the form of new money market instruments blurred the boundaries between the various aggregates and made the achievement of any target rates of growth unusually difficult. There is also some indication that the recession may have led to an increased demand for liquidity and precautionary balances. In 1982, growth in monetary velocity -- the rate at which money is used -- turned negative for the first time in nearly three decades as shown in Chart XI. Under the unusual economic and institutional circumstances of 1982, some temporary offset in the form of above-target rates of monetary growth was probably desirable.

As we look to the year ahead, it is clear that monetary policy goals will be important. Interest rates are still higher than they should be, and money growth must be returned eventually to the steady noninflationary pace envisioned by our overall economic program. One of the reasons interest rates remain high is that markets continue to be uncertain about the direction of Federal Reserve policy in the short run. The erratic movement of the money supply has been a factor underlying that uncertainty, and we hope that an even greater effort to avoid the wide swings in money growth seen in 1981 and 1982 will be undertaken by the Federal Reserve. Some of those fluctuations, of course, were the result of the institutional changes which have occurred and which have blurred the meaning of the traditional money supply measures. Nevertheless, as flows to and from the new money market deposit accounts and Super NOW accounts settle down and economic recovery moves ahead, the stage will be set for the Fed to follow a policy aimed once again at steady, predictable and noninflationary money growth.

Fiscal Policy

The objectives of our fiscal policy upon coming to office two years ago were two-fold. First, we believed and still believe it was imperative to correct the disincentives to economic performance that had been built into the tax structure over the years. These disincentives arose in large measure, not by design, but through the interaction of a high rate of inflation with a progressive tax system and historical cost accounting of depreciable assets. Second, it was equally imperative to reverse the seemingly inexorable growth of Federal spending, thereby freeing resources for use in the private sector.

The tax reforms that were put in place were designed primarily to restore an adequate rate of return of investment in plant and equipment and to put a halt to the steady upcreep of marginal tax rates on labor and savings income. The investment incentives were necessary to bring long-depressed U.S. investment rates and productivity growth rates up to acceptable standards. These measures will greatly improve our competitive standing in the world as economic recovery proceeds. For individuals, the tax cuts were needed to protect incentives and purchasing power. For the average taxpayer, they will only result in an actual dollar tax cut in 1983, after allowance for the effects of bracket creep and higher social security taxes. And that 1983 cut will be needed to offset scheduled increases in social security taxes in the future.

Even with the tax reforms fully in place in 1984, the marginal tax rate on American labor will be in the 40 percent range, including social security as well as Federal and State and local income taxes. For example, Mr. Chairman, a $25,000 a year worker with three dependents in the State of Iowa who does not itemize will be in the 22 percent Federal income tax bracket and the 8 percent state income tax bracket, and will face a combined marginal income tax rate of 30 percent. In addition, the worker and his employer will face a combined payroll tax of more than 13 percent, for a total tax on additional wages of over 43 percent. In recent years, it has cost a firm close to $1.70 to reward a worker with an additional $1.00 of compensation, a difference which can only be paid out of productivity gains.

It is of utmost importance that we do not revert to old policies by repealing the indexation to become effective in 1985 and relying on inflation to provide hidden, unlegislated increases in tax rates. What is needed now is not a reversal of previous reforms in the tax structure, but additional reforms to provide for even further reductions in disincentives. We will be taking a careful look at the structure of the entire tax system over the coming year.

We were relatively successful in working with the Congress to achieve our goals of tax reform, but we were less successful in the area of outlay control. While some of our proposals for outlay reduction were enacted in the Omnibus Budget Reconciliation Act of 1981 and in the First Concurrent Budget

Resolution of 1982, a major portion of the savings we hoped to achieve did not receive favorable action. This, along with much weaker economic activity than expected, has left us facing the prospect of large deficits even as the economy recovers. Deficits can feed on deficits, as each year's deficit raises the debt servicing costs for the forthcoming year.

This Administration has determined that deficits of the magnitudes bandied about in the press lately will not come to pass. Deficits of such size would drain the available savings pool, force up interest rates, and dampen spending on new business plant and equipment. This Administration came to office with a program of boosting the rate of capital investment in order to place the economy on a faster growth track, and we will not allow ourselves to be diverted from that goal. We will take whatever measures are necessary to narrow the deficit to acceptable levels. Preferably, the deficit can be narrowed from the outlay side. Total federal spending represents the amount of resources absorbed by the government at the expense of the private sector. This spending is financed by both taxes and borrowing, which in either case amounts to a drain on private savings. Only through spending reduction will the credit market find itself in a more favorable position. However, if we are not successful in reducing outlays sufficiently, and deficits still loom in the outyears even as the economy recovers, we are prepared to request additional revenue raising measures to be effective in those years. If the Congress chooses not to reduce spending, as we wish, then it is preferable to have the full cost of federal spending programs explicitly identified for the taxpayers who bear the burden of financing government. In the event taxes are needed, this Administration will do its best to structure the tax code in a way that minimizes disincentives for productive effort.

Policies for a Changing Economic Structure

Not only must we maintain steady monetary and fiscal policies directed at reinvigorating the private sector of the economy, but we must carry through with policies of reducing the regulatory burden on private industry. Noteworthy successes have been achieved in this area, particularly in the deregulation of the financial system. For the first time in the postwar period, small investors can count on being able to obtain market rates of return on their savings from banks and thrift institutions.

Further, we recognize that our economy and those of the other industrialized nations are undergoing a period of rapid restructuring. This is an era of rapid technological change, and comparative advantage in the production of many goods and services is shifting from the already developed to the newly developing nations. These forces must be encouraged and fostered. Those nations which expend all their energies shoring up declining industries and resisting change will find themselves with industrial bases that are obsolete and with declining relative standards of living. Their more foresighted and innovative neighbors will be moving forward and capturing newly opening markets.

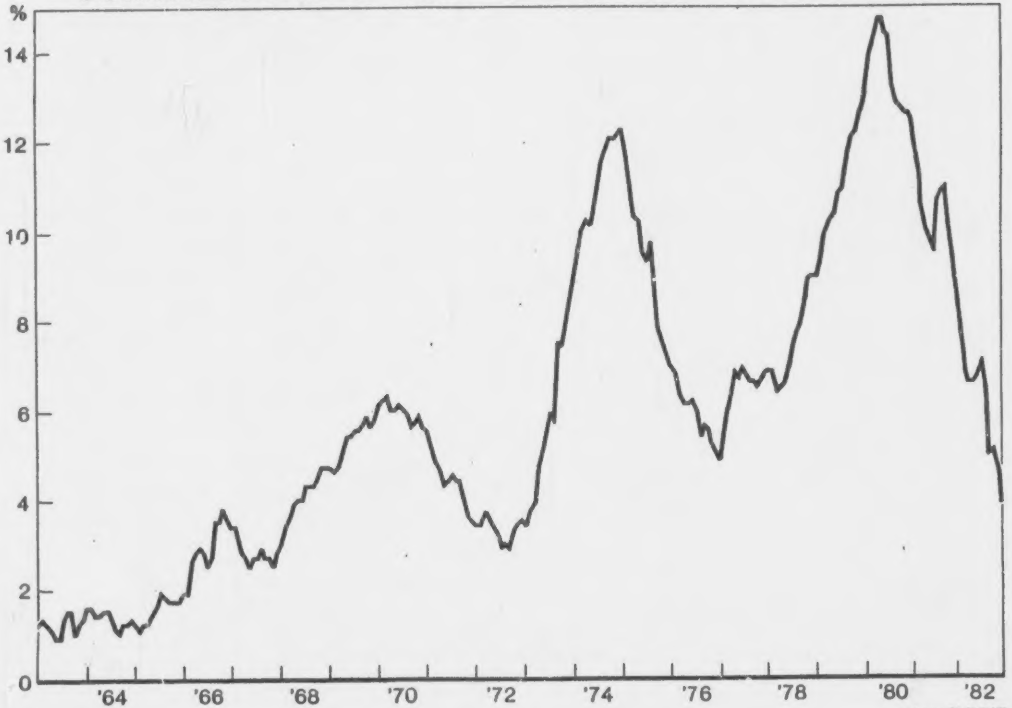
Government can ease this painful process, but the private sector must take primary responsibility for making this transition. In order to help smooth the process, the President has announced a program that relies heavily on the market mechanisms to deal with structural unemployment that stems from problems in both labor and product markets. Unlike cyclical unemployment, which will respond to the stimulus of economic recovery, structural unemployment requires more specific measures that address the unique problems of young people and the long-term unemployed. Thus, the President's program will emphasize training, retraining and relocation, and job-search assistance for workers facing the lack or loss of jobs even after an economic recovery. Other proposals will be designed to reduce the barriers to youth employment. Business management will face particularly difficult times, for they must develop their investment and new product strategies during times of both rapid transition to a noninflationary climate and rapid structural change. Individuals must exercise initiative in making the investment in human capital which will allow them to work effectively in this changing environment.

Finally, in setting the proper course of policy for the 1980's, we must work closely with the other industrialized nations of the world, so that we all can move forward together onto sustainable, noninflationary expansion paths. We must also work diligently and cooperatively to assist financially troubled newly industrializing nations to overcome their problems. The International Monetary Fund (IMF) plays an integral role in current efforts to promote the sound world economy and stable international financial system required for economic recovery in the United States and abroad. International negotiations are nearing completion on measures to assure that the IMF has adequate resources to help countries experiencing difficulties implement sound policies of economic adjustment. The participation of the United States in an increase in IMF resources is an essential complement to domestic measures to achieve sustainable economic growth and represents a valuable investment in defense of the economic interests of the American farmer, laborer, businessman, and consumer. Legislation providing for the U.S. share of the increase in IMF resources will be submitted in the near future and I urge prompt approval by the Congress.

Most important, all nations must eschew courses of protectionism in futile efforts to shift the burden of economic difficulties to others. Only through cooperation and common policies directed by common goals can we move forward together.

Chart I

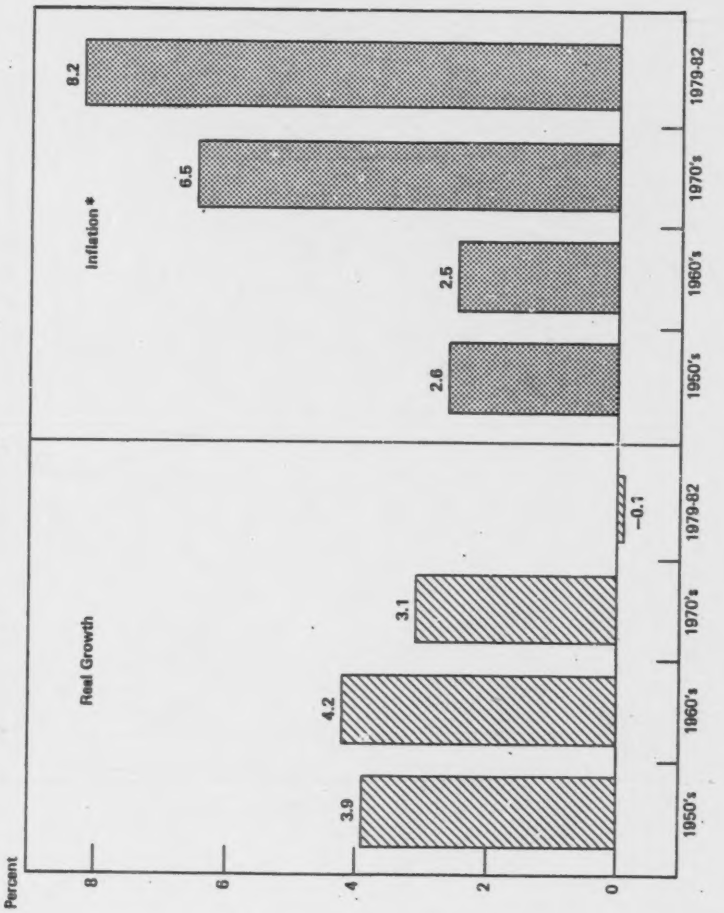
CONSUMER PRICES YEAR-TO-YEAR PERCENT CHANGES



January 21, 1983-A27

Chart II

ANNUAL RATES OF GROWTH OF REAL GNP AND INFLATION

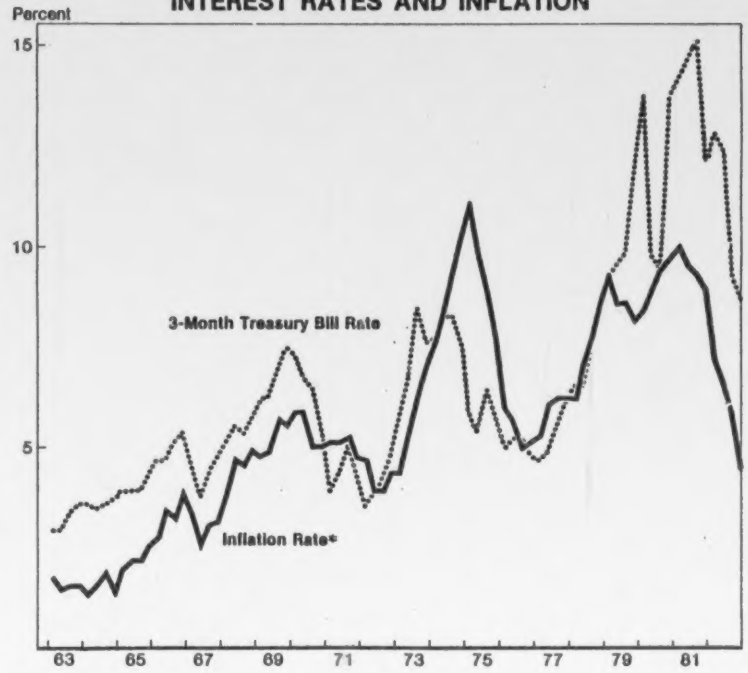


* Measured by GNP deflator

January 21, 1983-A211

Chart III

INTEREST RATES AND INFLATION

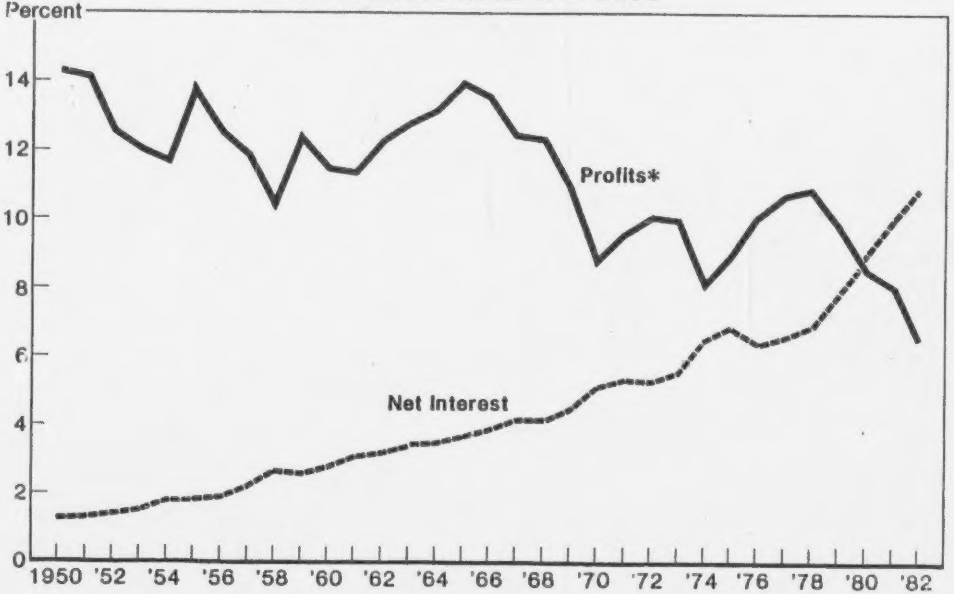


* Growth from year earlier in GNP deflator.
Plotted quarterly.

[illegible]

Chart IV

PROFIT AND INTEREST SHARES OF NATIONAL INCOME



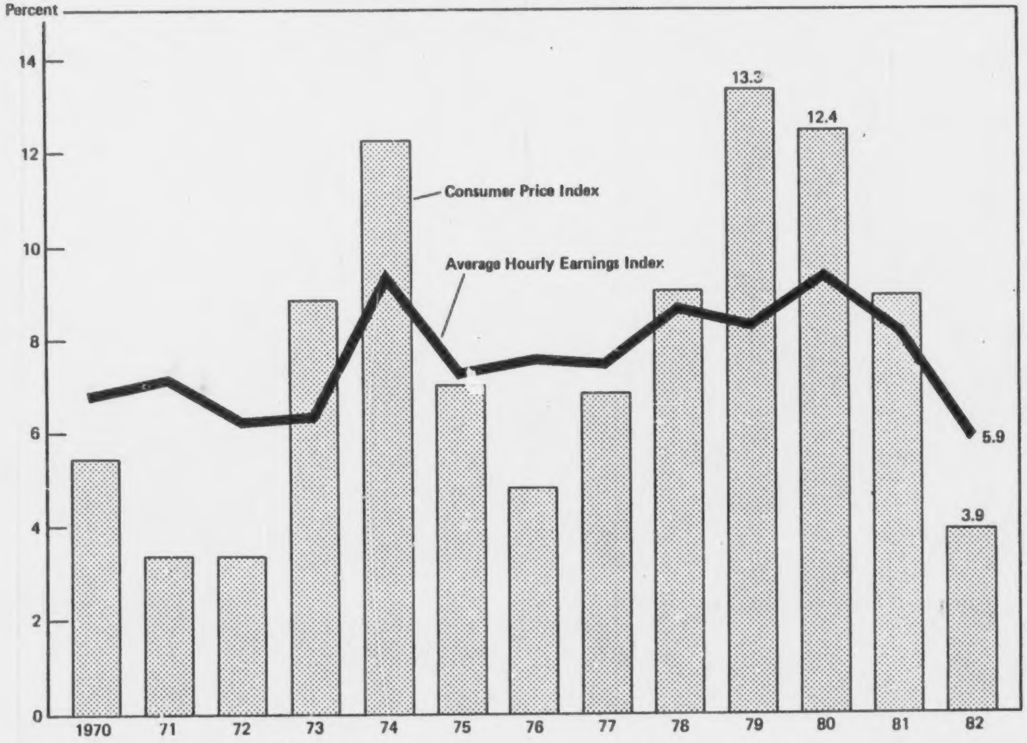
*Pretax corporate profits after allowance for depreciation and inventory profit.

January 18, 1983 A207

Chart V

YEARLY GROWTH IN INFLATION AND WAGES

(Percent Change from December to December)

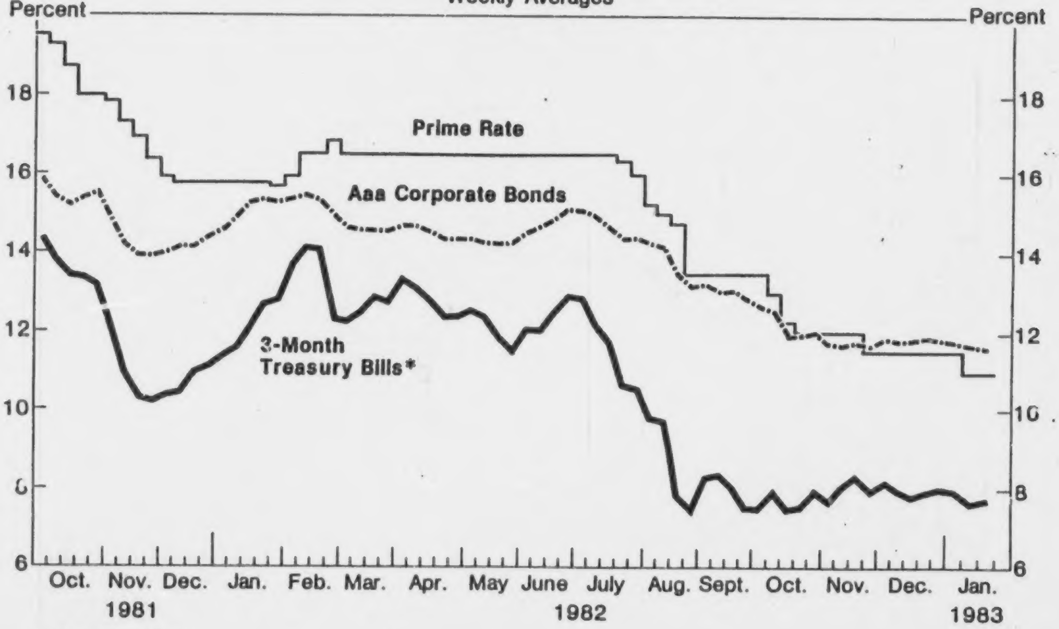


January 21, 1983-A209

Chart VI

INTEREST RATES

Weekly Averages

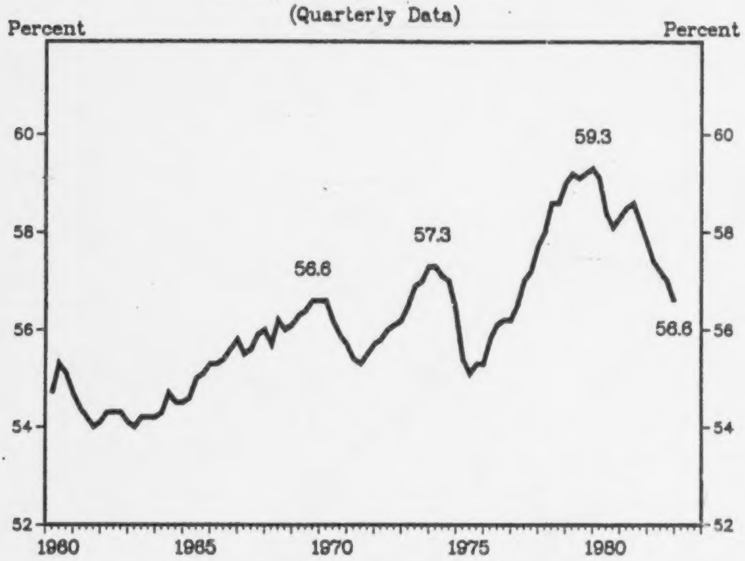


*Bank discount basis

Chart VII

Employment Rate

(Quarterly Data)



Unemployment Rate

(Quarterly Data)

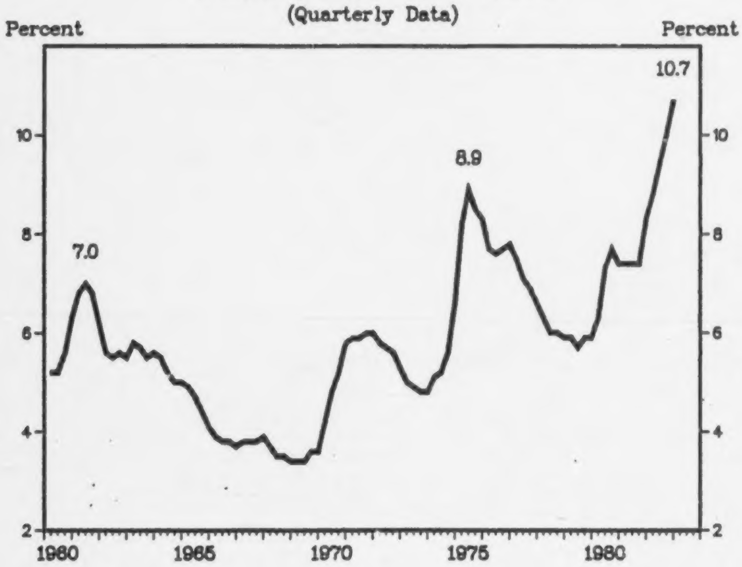
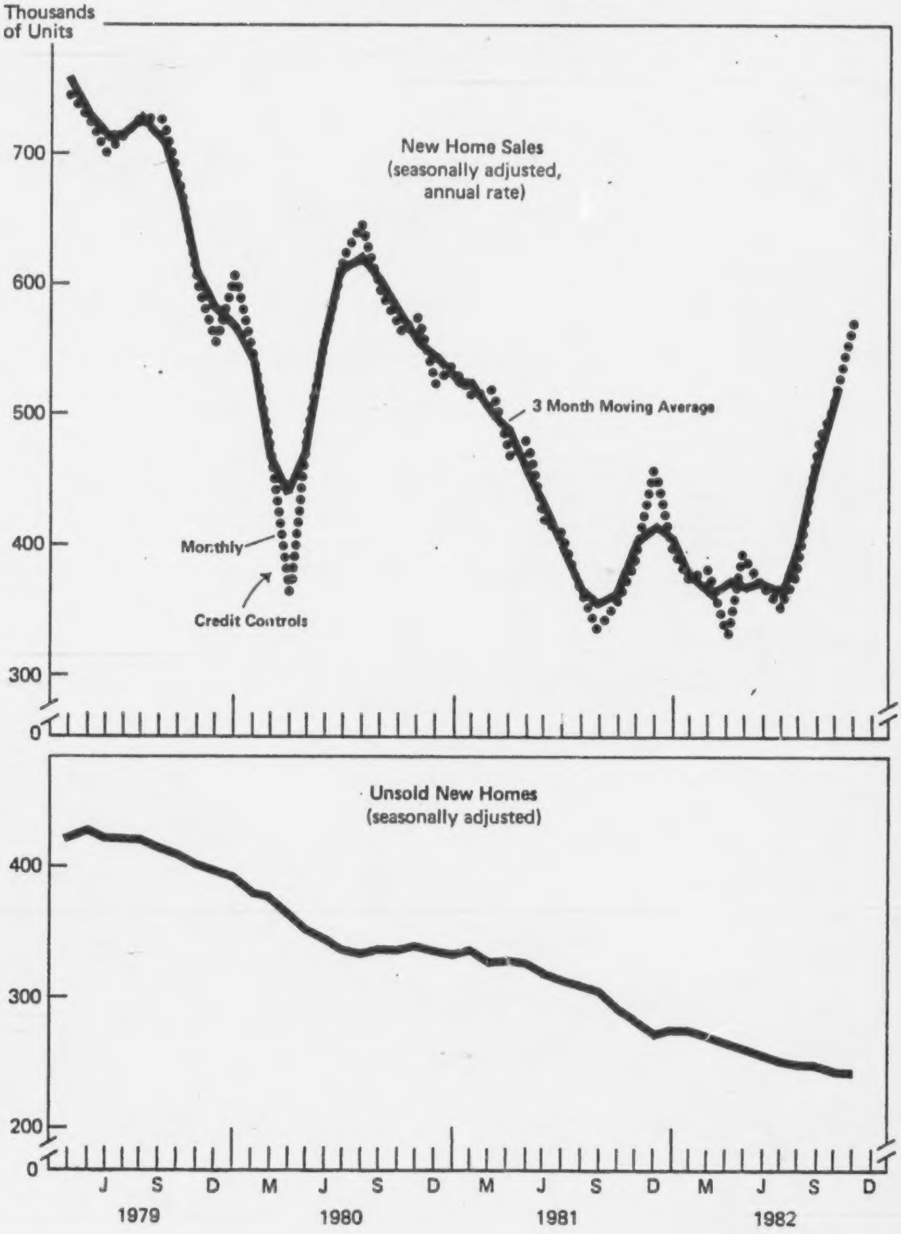


Chart VIII

NEW HOME SALES AND INVENTORIES OF UNSOLD HOUSES

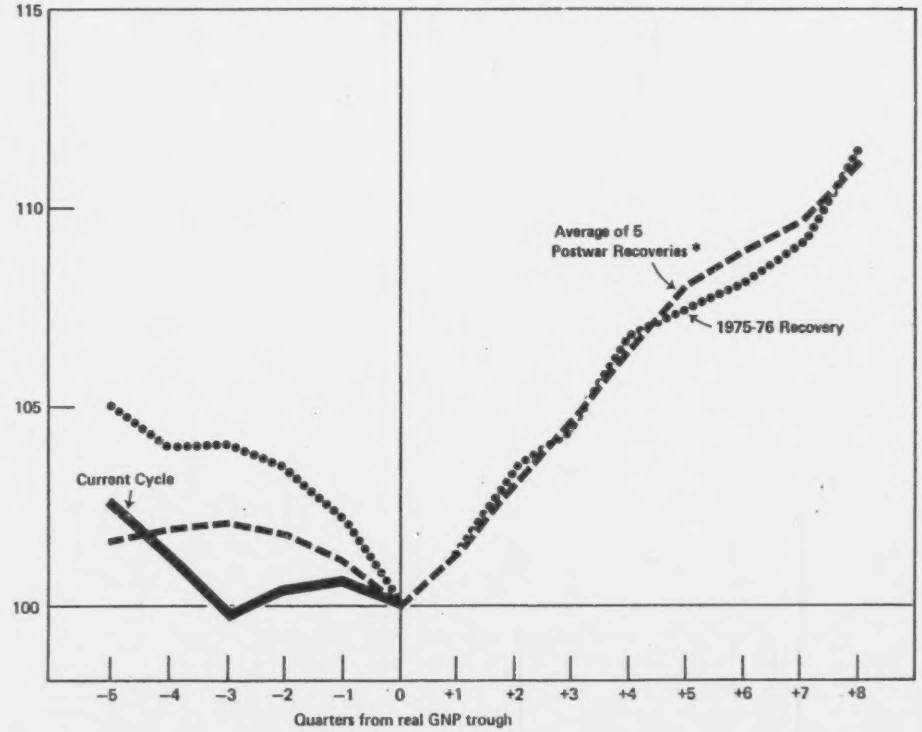


January 21, 1983-A212

Chart IX

THE PATH OF POSTWAR ECONOMIC RECOVERIES

Real GNP trough = 100

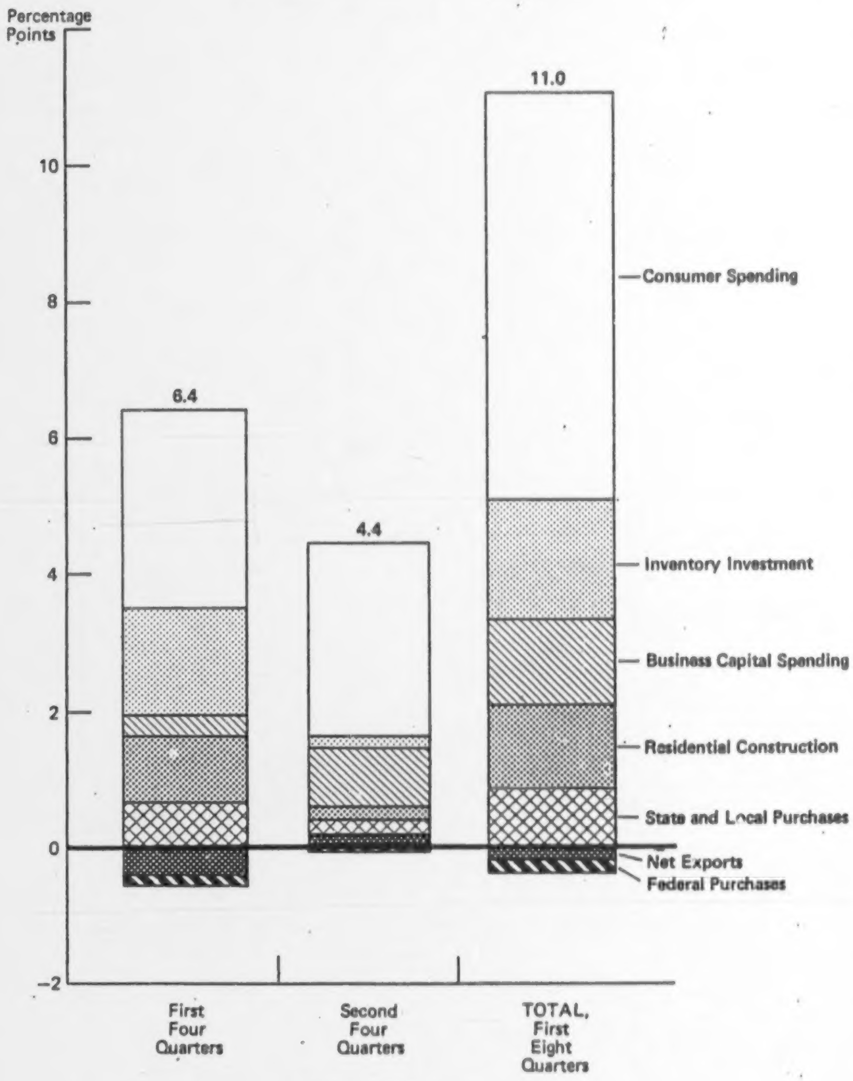


* Postwar recoveries excluding the Korean War period and the short-lived 1980-81 recovery.

January 21, 1983-A210

Chart X

CONTRIBUTIONS TO A TYPICAL RECOVERY* BY REAL GNP COMPONENT

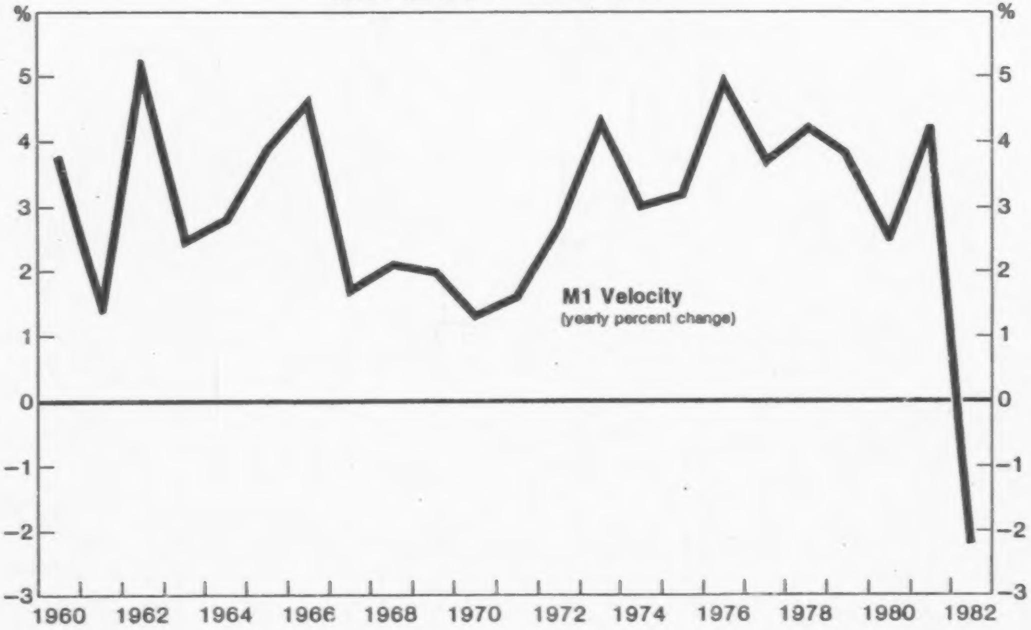


* Average of postwar recoveries, excluding the Korean War period and the short-lived 1980-81 recovery.

January 21, 1983-A213

Chart XI

MONETARY VELOCITY



January 12, 1983-A35

Senator **Jepsen**. Thank you, Mr. Secretary.

In your final remarks you touched on something that has concerned all of us. The news media has been filled with dramatic stories about the shakiness of claims on U.S. banks by foreign debtors—Third-World debts, especially Mexico, Argentina, Poland, as well as sizable domestic loan losses.

Are U.S. bankers running scared? Would you give us some perspective on this? Is it something we should lose sleep over? Could it result in a collapsed banking system, as some say? What can be done about it?

Secretary **Regan**. Well, I would say, Mr. Chairman, that the situation is still precarious. There are some huge debts. A number of countries are struggling to find foreign exchange to pay the interest and principal on their debts. Most of these countries are willing to make sacrifices but somehow or other they have to be tided over during the period in which the structure of their economies is changing.

For that reason, the IMF was created back in Bretton-Woods at the end of World War II. The IMF has been performing its task well. There have been, of course delays in getting the IMF financial arrangements started but there are other mechanisms for a short-term period until the IMF programs can take over.

This, of course, has been handled through the Bank for International Settlements in Basel, as well as by direct short-term loans from our exchange stabilization fund in the Treasury.

Among all of these various agencies, I think the situation has been managed well since it first cropped up in the summer of 1982. We are still faced with enormous challenges and were world oil prices to change we might even have other difficulties in some countries.

So we're not out of the woods by a long shot, but so far we have preserved the system. Our banks have taken losses as should be expected, after all. They're in the risk business and that's why they set aside reserves. Nevertheless, I think that you can be assured that our banking system is in pretty good shape in January 1983.

Senator **Jepsen**. Thank you. Mr. Secretary, in your view, are long-term interest rates low enough to sustain a recovery over the next several years or do they need to decline further?

Secretary **Regan**. I would think they'd have to decline further for a sustained recovery. They are low enough now to have started the recovery. As you well know, housing starts are way up; housing permits are way up. Why? Interest rates on mortgages are down to the 12- or 13-percent area. Construction loans are in the same area.

A turnaround in automobile sales also occurred in November when domestic manufacturers dropped their rates for carrying charges on auto loans for 1982 models down below 11 percent. I understand now the automobile companies will continue a similar program through March with the 1983 models. This is an indication that they recognize too that lower rates of interest produce additional automobile sales.

We do need, however, lower rates of interest generally, both short term and long term, to keep the recovery going after this initial start.

Senator **Jepsen**. One final question, Mr. Secretary. In your view, what are the most pressing economic problems confronting the Nation today as opposed to what the most pressing economic issues were when the Reagan administration took office?

Secretary Regan. The two main economic problems that are facing us now, quite obviously, are economic recovery and, along with that, reducing unemployment. These are the two main things that must be addressed right now.

When we first came into office, the main problem was inflation and, along with that, high rates of interest. When we took office inflation was running in double digits. Consumer price inflation had been 12.4 percent for 1980 and was even higher than that for 1979. The prime interest rate when we took over was 21.5 percent. Obviously, no recovery could have happened under that.

So our main problems at first were to get inflation and interest rates down, and we have succeeded reasonably well in both of these areas.

Senator Jepsen. Thank you, Congressman Hamilton.

Representative Hamilton. Mr. Secretary, what kind of changes should be made in monetary policy, in your judgment, to get these interest rates down?

Secretary Regan. Right now, of course, we have a very blurred situation as we have had since the latter part of last year, regarding exactly what the monetary aggregates are. This is because the Congress passed the financial deregulation bill which required the Deposit Institutions Deregulation Commission to come up with a new type of account. It's the money market deposit account. It's been a great success, a greater success than anyone had expected—about $150 billion has gone into those accounts.

At the same time, the banks in January brought out a new DIDC-approved account called the Super NOW account. I don't want to get too technical here, Congressman, but the Super NOW account has elements of a checking account—which belongs in M_1—and a savings account—which belongs in M_2. However, it is being put into M_1 by the Federal Reserve. It blurs things.

Representative Hamilton. Mr. Secretary, you have called for a more accommodative money policy in your speeches. Today, you avoided that phrase. Is there significance in the fact that you used it a few weeks ago but didn't use it today? What do you mean by more accommodative money policy?

Secretary Regan. Let me explain that first and then explain where I stand as of this moment. Accommodative means that the Fed has to supply enough money to get this economy going and to keep interest rates coming down. Because of the imprecision of the measurement tools at this particular time, as I described earlier, the Fed does not know whether it has supplied too much or too little. Growth in M_1 has been running at a 10- to 15-percent annual rate. Obviously, if that were a true figure, it's much too fast a pace of monetary growth and would lead to rising interest rates, not lowering them.

On the other hand, these may be misleading figures and the Fed should remain accommodative. We don't know. I don't think I dropped the adjective deliberately. I think it was just an omission.

Representative Hamilton. I take it you're satisfied then with the present course of monetary policy. You would not recommend any change in policy at the present time?

Secretary Regan. Not as of this moment. I think that they have to be very alert to try to determine whether they have put too much money into the system now. If they suspect that, they have to then gradually—and I repeat—gradually slow money supply growth. If they put on the brakes too quickly they would jolt this economy and we would not have the property. If they continue to pour in too much, it would scare people and rates of interest would go up.

So it's a very fine line that they have to walk and they have to be very vigilant at this time.

Representative **Hamilton**. Let me ask you about the President's proposal for a standby tax. Wouldn't it be better and more credible to make policy changes now to get the deficit down rather than kicking in a standby tax that has a large element of uncertainty to it? I'm really not sure it's credible. The Congress, so far as I know, has never enacted a standby tax. I just wonder about the uncertainty of it and the credibility of the standby tax. It seems to me if you're really interested in getting those deficits down in the outyears, then you've got to have a policy in place rather than a contingency plan.

Secretary **Regan**. Yon know, this is really a role reversal, Mr. Hamilton. I can recall being here testifying before Congress in 1981 and being asked why we wouldn't have a trigger on the third year of our tax and being very vigorous in saying, "No, no; we can't do that."

Representative **Hamilton**. We persuaded you last year, is that it?

Secretary **Regan**. And now that the administration has proposed one, we're being asked by those same people, "Why?"

Well, let me try to explain it. We know that we've got to get deficits down. If we don't get deficits down and if they remain as high as $150 or $200 billion 5 years from now—we know that that would mean higher rates of interest. People would be afraid that we were right back in the inflationary period. We have to have a credible stance.

Now assuming that the Congress will make the reductions in Federal spending that will bring down the deficits and assume that we have a recovery more vigorous than the one that we are projecting at this particular moment, there is no need for any more taxes.

However there are a lot of people that don't believe that either of those two things will happen and, accordingly, they need reassurance that we will demonstrate fiscal responsibility. Hence, what we're saying to the Congress is that if you pass these freezes and the budget cuts that we're recommending, then you can put in a tax to make it more credible. Pass it this year, but don't put it into effect in 1983 or 1984 because we're just emerging from a recession. We want the savings and investment features of the tax cuts to go to work so that we can prolong the recovery.

But if the deficits persist in those outyears, in fiscal 1986, 1987, and 1988 and they are of a magnitude greater than 2½ percent of gross national product, then we're going to have to pay for it. If we don't make the spending cuts and if we don't have the growth, then put taxes into effect to reduce deficits.

There will be another Congress in 1985, granted, and that Congress will act responsibly probably. However, at this point I think people would like more reassurance that a deficit-reducing measure is already in place.

Representative **Hamilton**. Thank you, Mr. Chairman.

Senator **Jepsen**. Congresswoman Holt.

Representative **Holt**. Thank you, Mr. Chairman.

Mr. Secretary, the Wall Street Journal has been editorializing a lot these days about the IMF or our increased participation in it being simply a bailout and you certainly are advocating our paying more attention to it. Is it simply a bailout or is it absolutely necessary?

Secretary REGAN. Mrs. Holt, I don't think that it's a bailout for the simple reason that as—let's take Mexico as the prime example—when the IMF went in to loan money to Mexico to help correct the imbalance in their external payments situation, the banks had to go right along with the IMF. They're putting more money into Mexico today than they had in 1982. They are not getting paid back by the IMF money. IMF programs are not used to pay off banks. It's not the case in Brazil. It's not the case in Yugoslavia. It's not the case in any of these countries.

As far as what we're requesting for the IMF, it has no budgetary implications. When called upon to put additional funds into the IMF we get an increase in the U.S. reserve position at the IMF. It's a balance sheet item. You give on one side; you get back on the other. There's no effect on the budget. It's true that we do have to go out and borrow that money so to that extent it has an effect on the money markets, but it has no effect on the budget if we were to have an increase in our quota for the International Monetary Fund.

Representative HOLT. But if you're bolstering the country, aren't you really in effect bailing out the banks ultimately?

Secretary REGAN. No, no more than trying to keep a country like Mexico going. Right now our exports to Mexico are off considerably. What we're trying to do is to keep Mexico going. We have an enormous amount of trade with Mexico, both agricultural production as well as manufacturing production. If Mexico were to go under, what are the consequences? What happens to our exporters? What happens to those who manufacture or produce for export? Certainly they're not going to be able to sell and if this happens in country after country there's chaos in the world, and certainly that doesn't help our own domestic economy.

Representative HOLT. Another point, you say that we see some evidence of our productivity increase. Now I'm worried about that. I think that's the ultimate solution to a lot of our economic problems and we made some starts in tax policy in 1981 to accomplish increased productivity but then we took some of them back in 1982.

What is the Treasury Department considering in the way of tax policy changes to encourage plant and equipment spending? What do we do to get that moving?

Secretary REGAN. Our plan is to stay right where we are. I think we've confused the business world enough at this point as far as forward planning is concerned from the tax point of view. We had one thing in 1981. Perhaps we were too generous. At least it was the opinion of some of us that we went a little bit too far. We took back some of that in 1982. I think that we should just hold where we are now and let business plan ahead for 3 to 5 years without having to think, "Oh, My God, are they going to have a different type of taxi;" or, "If we do this, will we be able to have any certainty as to what the financial outcome will be?" I think if we just stay where we are, we're in the proper mode to increase our productivity further through new machinery and equipment and new plant and the like.

Representative **Holt**. But what evidence do we have that there is an increase in productivity?

Secretary **Regan**. Productivity was up at a 4-percent annual rate in the third quarter. This is very unusual during a recession. If we could do that during a recession, by the time real growth resumes and we get our new machinery, productivity improvement will certainly continue. As you know, new plant and equipment expenditures have been way down, yet despite this, we had the increase in productivity. So I think that when we do get new plant and equipment expenditures up, productivity will continue to look good.

Representative **Holt**. Do you have any evidence that the industrial community is regaining confidence?

Secretary **Regan**. Well, this is one of the things I alluded to in my prepared statement. We're going through a change in the economy from the old smokestack industrial United States into what people have variously called the services industries or the information industries. Spending in the very highly industrialized industries—steel, transportation equipment, and the like—has been declining.

Capital spending is usually a lagging indicator. Businesses wait until they see the upturn and are well into utilizing present plant capacity. Present plant utilization in some industries is now less than 50 percent of capacity. I think that as it gets up into the 1970's and 1980's that's when you see the heavy industries start to build new plant and equipment.

Representative **Holt**. Thank you.

Senator **Jepsen**. Senator Proxmire.

Senator **Proxmire**. Mr. Secretary, I first want to congratulate you on one of the most realistic forecasts that I've seen the administration make. It's honest. It's realistic. It may not be realistic enough, but it's certainly an improvement over what we've had in the past.

Normally, administrations greatly overestimate the success of their programs and assume we're going to make a lot of progress.

Nevertheless, there's a problem here. You're an extraordinarily intelligent man. You're dedicated. You're hard-working. You're a brilliant business success. But you'll go down in history as the Secretary of the Treasury of the administration with the worst fiscal record in history if you don't get control of this deficit. The deficit is certainly going to be the worst in history and I think as it comes out in a few days the budget is going to show us by far the biggest not only peacetime deficit, the biggest we've had in wartime. There are many charts attached to your prepared statement. There's no chart on the deficit.

The vice chairman of the committee referred to the President's proposed contingency tax increase. It seems to me that's a diversionary tactic to get our minds off the astronomical deficit and we need to do something about them.

Why not bite the bullet now by suspending the 1983 tax cut, by suspending indexing, by really moving in on military procurement which is going to hit exactly in the outyears when the deficits will be the most damaging, and providing the basis in recognition on the part of the business community that we do have our fiscal policy under control and you won't have these terrifically big demands on the credit market in the public sector that are going to make interest rates go right up again.

Secretary Regan. That's a tall order. I thank you for the flowers, but as far as the question is concerned, the 1983 tax reduction is the first time that the average taxpayer, low income, middle income and the like will get a tax cut since the Reagan administration has been in office.

The 1981 tax cut of 5 percent for the 3 months and the 10-percent reduction starting July 1, 1982, just about kept the taxpayer even with the increase in taxes from social security and bracket creep.

1983 is the first time that the actual tax decrease will take effect. We're just emerging, as we all agree, from this recession. Our forecast indicates slow progress in the first 6 months of this year and better progress in the next 6 months. Were we to stop the tax cut that people have been planning on for 3 years and snatch it away from them just as they are about to get it, what's going to be the effect on savings, on investment, even on consumption?

Senator Proxmire. But, Mr. Secretary, we've given them a tax cut of 5 percent in 1981, a tax cut of 10 percent in addition to that compounded in 1982, and what you're really doing is not to cut taxes but to shift the tax burden. People in the upper income brackets, $50,000 or above, will pay less and they will pay a lot less; and people with modest incomes are going to pay more social security taxes, more gasoline taxes. The taxes on them are going up. It's just a shift in the distribution of the tax burden. Isn't that correct?

Secretary Regan. No, that's not correct. What is happening is that in those lower brackets, by giving them the 10-percent tax cut now, we actually give them an effective tax cut, even including social security but not gasoline. Gasoline depends—we can't figure out, you know, who's going to use what. But just on a straight income tax basis and social security tax basis, the $20,000 a year adjusted gross income bracket gets a small cut after the effects of the 1983 tax cut. Without that cut, there would be a tax increase.

Senator Proxmire. How about the $15,000 bracket?

Secretary Regan. $15,000?

Senator Proxmire. $20,000 is about break-even. You've got about half the people in this country below $20,000.

Secretary Regan. Well, I've got some figures here.

Senator Proxmire. If you crank in the social security increase——

Secretary Regan. In the $10,000 income bracket, the total, after you add in everything and after you subtract everything, comes to a tax deduction under current law of approximately 9.6 percent, call it 10 percent overall. In the $50,000 bracket it amounts to 10.4 percent, call that roughly 10. It's around the same thing. So that the differential is the same in most of the tax brackets.

Senator Proxmire. Well, I won't persist in that further except that, of course, what is happening is that the State and local governments have imposed primarily regressive taxes.

Secretary Regan. Well, let me answer that because that's the second part of your question. As far as indexing is concerned, I think that, having introduced that principle into the Tax Code, we ought to leave it. We have said that there will not be unlegislated tax increases in the future, that if the tax code is indexed to inflation the taxpayer will be kept even with inflation and there will be no bracket creep. I think that that is a very sound principle and should be maintained.

Now we haven't tried to divert anything with this proposed contingency tax. What we're saying is that, if needed, we're willing to go along with taxes; we would rather have the deficit come down through growth; we'd rather have the deficit come down through spending cuts; but if we don't get reduced revenues that way, then we would be willing to raise taxes. However, we don't think it's necessary until 1985.

Senator PROXMIRE. Mr. Secretary, my time is up, but let me just say the difficulty is that you talk about creating more uncertainty by moving away from this July tax cut but then you come in with one of the greatest uncertain tax proposals we've ever had which is a contingent tax increase. Nobody knows whether we'll have it or not. It depends on all six conditions, I guess it is, isn't that right, which we may have in 1985–86? And if there's one thing the business community wants more than anything else, it's certainty.

Secretary REGAN. Well, we believe that our plan adds to certainty. If Congress would pass this tax, it would actually be known what the tax would be. It would be a surcharge type.

Senator PROXMIRE. Depending on if conditions are met?

Secretary REGAN. If conditions are met. These would not affect, as they stand now, business decisions at that time.

Senator JEPSEN. Mr. Secretary, will it be possible to have a copy of that for the record?

Secretary REGAN. Yes. I'll submit that for the record.

[The information referred to follows:]

TREASURY FACT SHEET

Contingency Tax Plan

JANUARY 31, 1983.

The Administration fully supports the tax reduction program begun in 1981, including the third year of the tax cut scheduled for July, 1983, and indexing of the rates beginning in 1985.

To assure the reduction and eventual elimination of deficits over the next several years, the Administration proposes a contingency tax plan for enactment in calendar year 1983. This plan is designed as a stand-by measure to insure that budget deficits for fiscal years 1986 and beyond will be reduced (by about one percent of GNP) in the event that economic growth sufficient to hold those deficits to two and one-half percent (or less) of GNP does not materialize.

The contingency tax plan could consist of both:

A surcharge of 5 percent on taxes paid by individuals and corporations and

An excise tax on oil, both domestically produced and imported, that will raise revenues of about $5 per barrel.

The contingency taxes will become effective October 1, 1985, only if three conditions are met: (i) Congress adopts the Administration's spending reductions and structural reforms of federal entitlement programs, (ii) the unified budget deficit for fiscal year 1986 is forecasted by the Administration, on July 1, 1985, to be above two and one-half percent of GNP; and (iii) on July 1, 1985 the economy is growing.

If the contingency taxes become effective, they will remain in place for up to 36 months. The contingency tax plan is designed to raise revenues by an amount approximately equal to 1 percent of GNP. Specifics of the plan we will submit to Congress could modify slightly the estimates appearing in the Budget.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for a very fine statement.

I wanted to pursue just a little further this question that you brought up with one of your earlier charts about the disparity between the interest rates and the actual rate of inflation now. I think the President referred to it last night as the "fear factor," but you've talked about uncertainty and I think that's somewhat the same thing.

Don't you believe that if the Congress would actually do the right thing on the entitlement programs which are over half the Federal budget that that would remove a great deal of—and by saying "the right thing," I mean put some equity back into the cost-of-living increases as opposed to a wage index. We can see that there's been no equity for the last 10 or 15 years between people who are working and paying those taxes and the people who are receiving them. The people receiving them have received a much greater increase than the wage earner's income has actually increased or in the case of social security it's even without taxes.

There are many people in my State that actually earn, say $15,000 a year and they pay taxes on it, and try to raise a family. But there are people who are receiving social security who get $15,000 a year for a married couple from the Social Security Administration, with no taxes on it. And yet they are continually buffeted with a 100-percent CPI index, but the wage index in many cases with some companies have been negotiated downward. I have had many of my constituents tell me that all their employees took a 10-percent pay cut last month or the month before to keep the company afloat.

Why is it that this administration is so afraid if that seeming problem is so apparent to the financial markets—every person I've talked to in the financial business tells me that once Congress fixes entitlements and this outflow and reforms, then the interest rates will come crashing down and you'll get the economic recovery. Why are we so hesitant to take that issue on and confront it with the American people?

Secretary REGAN. Well, first of all, I think it's not just entitlements but its in quite a few other areas of the budget.

Senator SYMMS. But it is over half the budget.

Secretary REGAN. It is roughly half the budget.

Senator SYMMS. We have literally frozen the nondefense appropriations account since the Reagan administration took over.

Secretary REGAN. The uncertainty comes from the question of how are we going to finance spending? Are we going to finance it by pumping in money and thus bring back inflation? Are we going to correct it by lowering the deficits to where they're a smaller portion of gross national product and thus take less out of the savings pool that's available for the private sector.

As far as entitlements are concerned, we are trying to address that problem, as well. In the President's statement last night you saw——

Senator SYMMS. Well, I'm glad the President addressed it slightly, but its very meager when we talk about 6 months of a delay of COLA when maybe if we had a 2-year delay we might actually see economic recovery and then we could go back and start increasing it again to those with the low incomes.

Secretary REGAN. As you know, Senator, it is going to require a bipartisan approach in order to accomplish a reduction in outlays. The Social Security Commission came up with its bipartisan solution which was a 6-month freeze in the social security COLA. We're trying to put symmetry between that and other COLA's in Government as a start.

Senator SYMMS. But with that social security solution for an example, 76 percent of that is to be solved by raising taxes: isn't that correct?

Secretary REGAN. Well, it depends upon your definition of what is a tax. Now a lot of people say that by taxing those that have as a couple $25,000 or $20,000 as a single person you're actually reducing their benefits. Some will call it a tax. Some will call it a reduction in benefits. So it's hard to put precision on it but I'd like to remind you that there is one other thing in the social security agreement that I hope is passed by the Congress. That is in 1988 the COLA's move to the lesser of wages or prices and I think the sooner that is done for all COLA's the better. I think you'll see a lot of those costs go down.

Senator SYMMS. Senator Proxmire talked about why not do some things now—if it's a good idea in 1988, why wouldn't it be a good idea in 1983 so we could get the economic recovery underway?

Secretary REGAN. What we tried to do initially is to stay with the 6 months. If the Congress wishes to move the 1988 proposal forward, we'd go along with them.

Senator SYMMS. Well, I appreciate that comment. I'm very concerned that the social security solution that the Commission came up with would cause more unemployment because it is a tax on employment and it becomes very expensive for small businesses to hire people as well as for people to pay that tax that are working.

With respect to the uncertainty, do you think there could be any possibility that the recent, more accommodative attitude that the Fed has had has stopped the decline in interest rates--I notice since October interest rates have started coming down—since the Fed has apparently been more accommodative because there might be a fear they're going to start pumping the money again and inflating the currency?

Secretary REGAN. That is one of the fears in the marketplace. There are an awful lot of other fears in the marketplace, as well.

Senator SYMMS. Along that line, my friend, Milton Friedman, said to me one day that if you'd fire the Federal Reserve Board and put a computer clerk over there to run it so we could have some stability that we'd have lower interest rates. Do you agree with that point of view?

Secretary REGAN. I think that perhaps Mr. Friedman was exaggerating slightly as he's wont to do occasionally.

Senator SYMMS. What do you think Beryl Sprinkel would say to that?

Secretary REGAN. The same thing.

Senator SYMMS. Could I ask one brief question, Mr. Chairman? I see my time is up, but I think it deals with the tax questions that have been asked here and I'd appreciate an answer.

You said you had nothing in mind as far as changing the tax code at this time and I agree with you that we have changed it too much already to get rid of the confusion.

In 1978, before the Reagan administration came to town, Congress passed an income tax bill which lowered the capital gain rate, which I'm sure you're very aware of. When that passed, Treasury was supposed to do a study over what the actual loss to the Treasury was in lowering the capital gains rates ultimately down through, I think, 48 percent or 46 percent down to 28 percent at that time. We've since lowered it again and if I'm not mistaken that study should be completed by now. Has it been completed and, if so, do you have any information as to how that actually affected the revenue to the Treasury?

Secretary REGAN. Obviously, I'm not informed on that, but one of my assistants here tells me that the study is due out in 2 months and its initial showing is that revenues went up as a result of lowering the tax, not down. In other words, we got more revenues from less taxes than we did in the prior year 1978.

Senator SYMMS. Well, I thank you very much. If that is the case, maybe we could have one change in the tax code and that is to abolish the capital gains tax.

Senator JEPSEN. Congressman Obey.

Representative OBEY. Mr. Secretary, it's good to see you again. I hate to start off by getting into one of these "Who shot John" situations again, but in light of the fact that you in your prepared statement early on and the President on page 2 of his statement last night made the same statement, I really wanted to raise a question about it.

You implied in your prepared statement and the President certainly did last night that you inherited the current recession from the preceding administration. Could you tell me when the National Bureau of Economic Research says that the current recession began?

Secretary REGAN. July 1981.

Representative OBEY. July 1981. Who was the chairman—who's the past chairman of that organization?

Secretary REGAN. I believe it was Martin Feldstein.

Representative OBEY. I do, too. It seems to me, Mr. Chairman, that for the record it ought to be stated that from July 1980 through July 1981 when the existing recession began, employment rose by 2 million, unemployment fell by one-half million, and when this President took office in fact unemployment was on the way down and the GNP in real terms was on the way up, just so the record is somewhat clear on that.

Secretary REGAN. But there are some economists, Congressman Obey, who are saying that the short-lived recovery in the latter half of 1980 and the early part of 1981 really may be an abberation when economic historians look back on the record.

Representative OBEY. Well, it may, but I will have to for the moment take the word of Mr. Feldstein.

Let me ask about the International Monetary Fund. On my Foreign Operations Subcommittee I've carried so much water for both Republican and Democratic administrations that I've felt I needed a wet suit from time to time. How much are you asking us to support increasing the IMF contribution by over the next couple years?

Secretary REGAN. I can't answer that question with precision. Right now we're still negotiating. The U.S. position on the increase in quotas is to keep it as low as possible. Other nations are urging us to get it up higher. The final decisions are to be made at a meeting here in Washington February 10 and 11, but all I'm saying is that we're going to keep it down as much as possible.

Representative OBEY. But will it be single digit or double digit?

Secretary REGAN. The current bid, if I might put it that way, is an increase of 40 or 50 percent. When we were in Toronto at the last full meeting of the IMF which was Labor Day of 1982, there were those who were urging a 200-percent increase or at least 100 or 125 percent. We now have it to where it's been a 40- and 50-percent increase.

Representative OBEY. Then I have a couple questions following that up. Maybe I'm seeing something that isn't there, but my understanding is that Secretary Schultz has asserted that for 1983 his chief goal is to find a way to bring about expansion of the world economy. I sense that when Mr. Sprinkle said somewhat the same thing that there was at least some cautionary message sent to him to ease off a little bit and I got the impression that you were afraid that there might be danger of putting too much of an emphasis upon rapidly increasing world economic growth. Is that a correct assessment or not?

Secretary REGAN. Partially. Let me explain what happened here. We all want growth in the world economy. Growth, though, has to start someplace. It is being asked of the industrialized nations who have brought inflation down that they be the ones to start growing. This, in turn, helps others, including developing nations.

However, I want to make sure I understand what they mean by growth. If growth means inflation—let's inflate all of our economies and let's get started again—I don't go for that. Real growth, yes. Inflationary growth, no. That's what I'm worried about.

Representative OBEY. Well, I can understand that but I must say that I'm a little worried about your worry because as I read the reports the OECD indicated that a 1-percent reduction in world interest rates would lower the annual net interest payments in the four high debt countries; namely, Brazil, Mexico, Argentina, and South Korea by $1.7 billion, and I'm just concerned about the administration caution in this regard. If it's too cautious it might wind up, in effect, encouraging a continued sluggish world economy which means that we've got to jack up our contributions to the IMF by a lot more than I think the Congress is going to be happy doing.

Secretary REGAN. Well, let me say that I don't think we will be too cautious, but we have to be sensible also. I just want a definition of the terms and an understanding among the finance ministers as to exactly what we're saying when we urge all the nations of the world to expand their economies or to get more rapid growth. That must not be a plea to inflate all of our economies again.

Representative OBEY. Just one last question because my time is up. The President indicated last night he wanted to simplify the tax code. How many recommendations did he have in his speech last night for adding further wrinkles to the Tax Code? Was it four or five?

Secretary REGAN. I'm not sure of the exact number but there were several. What he's talking about, though, on the simplification, is along the lines that have already been suggested. The Senate has had hearings on it. There is a proposal in front of the Congress, the Bradley-Gephardt bill. There are many bills of this nature to really overhaul the entire code. In the meantime, these other——

Representative **Obey**. In the meantime, the administration is recommending more complication rather than more simplification.

Secretary **Regan**. I don't think we're adding that number of complications. What we're suggesting for the most part are the tax cuts. The educational assistance program will be a tax cut. The tuition tax credit will be a tax cut. We're not really advocating more complicated taxes.

Representative **Obey**. Well, if I could just say, virtually every complication in the Tax Code is a tax cut to somebody that people generally don't get.

Secretary **Regan**. Perhaps. Incidentally, Congressman Obey, I don't want to throw flowers your way, but I do appreciate all the help you've given us in the past and hope it will continue on the international scene.

Senator **Jepsen**. Congressman Snowe.

Representative **Snowe**. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for being here.

We've mentioned this morning the fears and uncertainty about the prospects for the future of the economy and recently, as Representative Hamilton mentioned, the fact that you suggested an accommodative monetary policy. Paul Volcker has indicated the budget deficits are a threat to economic recovery.

As I see it, we could eventually be on another collision course with the Federal Reserve Board's monetary policy and large deficits that have been estimated for the future, even based on the administration's proposed savings and reductions for 1984, 1985, and 1986. Now I think the fear has also been articulated about the future that the Federal Reserve Board might establish a policy to defuse the inflation-hedging psychology that appears to be among potential investors.

So this could hinder our economic recovery in the future. How can we avoid this collision course? It's happened before and clearly it could happen again. When you were suggesting an accommodative monetary policy, have you reached any accommodation with the Federal Reserve Board because clearly, if it does not go hand in hand, we are going to face exactly the same situation we faced just a year or so ago.

Secretary **Regan**. Well, I think the Fed understands the economic conditions of the country at this moment. The Fed wants to have an economic recovery. They have said so many times. They have been trying to do this since they changed their posture in July 1982 and started supplying more money.

I think that what Mr. Volcker was saying was that the large deficits that were being bandied about in the press—$200 and $300 billion deficits—would make it very difficult to handle monetary policy and I would agree with that. We have no intention of having such deficits. Therefore, I think the Fed can accommodate the growth policies that we want.

Representative **Snowe**. You suggested that in order to have an economic recovery or, being poised for an economic recovery, that we could continue or at least begin that recovery with current interest rates, but that beyond that we're going to have to reduce interest rates.

Given the tendency of the Federal Reserve Board in the past, I just wonder the extent they're going to be willing to reduce those interest rates any lower, given the size of the deficits that have already been projected even with the proposed savings that have been recomommended by the administration in his state of the Union address last night which projects $189 billion for 1984. What I would just hope is that somehow we could have a consensus or agreement with the Federal Reserve Board and the administration, because if the administration is going off in one direction and the Congress and the Federal Reserve is going off in clearly another direction, then we're never going to have the kind of economic recovery that we would hope. I would guess that the biggest fear that seems to be looming out there is the fact that those interest rates are going to go back up and once they begin in that direction I think it's going to choke off the recovery.

So I'm just wondering if somehow we can develop a strategy in concert with the Federal Reserve Board. If that doesn't happen, it seems to me Mr. Volcker is indicating, based on his statements of recent days, that he's concerned about the size of those deficits. I'm not sure that $189 billion is sufficient for 1984.

Secretary **Regan**. Well, obviously, I can't speak for the Fed nor can we order them to do anything. Congress in its own wisdom saw fit to make the Fed an independent agency. As a result, we have to have agreements with the Fed rather than having as a policy that they do what we say. I think that there's no quarrel between us and the Fed as far as how to handle the current monetary situation. As I indicated in my previous answers, the precision right now of how well or how poorly the Fed is handling money is not known because we're so uncertain as to what the measurements are.

I think that the Fed has to, of course, have a less accommodative policy the longer the recovery persists. That would mean 9 months, a year or 2 years from now they probably should be in a much less accommodative stance than they are now, but they should do that in a gradual fashion.

I think the erratic course, whereby they go from all growth to no growth and then back to all growth, is what causes the worry and the uncertainty in the money markets. We're hoping that with some of the new techniques—lag reserves and things of that nature—that they can come up with more precision.

Representative **Snowe**. Thank you.

Senator **Jepsen**. Congressman Scheuer.

Representative **Scheuer**. Thank you, Mr. Chairman.

It's a great pleasure to have you here and I appreciate your most interesting and candid testimony.

I have two questions, Mr. Secretary, one a domestic one and one an international one.

Representative Holt referred to the question of productivity and, of course, we are all concerned about it. I was in Japan the summer before last with Senator Roth and Senator Hawkins and we saw robots making automobiles and robots making machine tools and I think we're all deeply concerned about the ability of our country to compete with the Japanese, the Swedes, the West Germans in international global trade if we don't get our productivity act together.

Representative Holt mentioned the question of the incentives for new plant and equipment. It's a lot more than incentives, although it's certainly that. It's incentives for additional research and development. It's some kind of incentives to defuse the labor-management controversy over the introduction of new technology. It's the business of increasing the number of engineers and scientists and mathematicians that we're training at about one-quarter of the rate of Japan. It's a matter of looking at our antitrust legislation that was passed a century ago almost at a time when there wasn't any question about the urgent need for American industry to get its act together and perhaps for individual firms to be enabled and encouraged to cooperate in engaging successfully in international competition, competition on a global scale. There seems to be the great danger that we'll be wiped out of global trade in automobiles, wiped out of global trade in pharmaceuticals, wiped out of global trade in electronics and other matters.

So this is tremendously important. The question you raise and the hope you raise is that if we increase our GNP at a 1¼-percent rate in a matter of a few years we would have wiped out our deficit.

Does the administration have any plans for producing a comprehensive package of legislation that would go to the various standing legislative committees that taken altogether would provide a comprehensive holistic mosaic of legislative programmatic items that would substantially increase our productivity and substantially enhance the degree to which American business and American initiative and American capital could compete globally and successfully in global commerce?

Secretary REGAN. I'll try to keep my answer succinct. The answer is, yes. Starting off with productivity and R&D, we have made the tax aspects advantageous for corporations to have new machinery and equipment, robotics, and the like through the Tax Act of 1981 and we didn't do great damage to that with the Tax Act of 1982.

I do not want to be one who always looks at silver linings, but still the most recent recession has taught us quite a bit about labor-management relations. I'm very surprised, pleasantly so, at the way labor and management have gotten together particularly in distressed industries to make certain the work practices, wage rates, and things of that nature are modified in order to get those industries back in a more efficient way.

Antitrust, you will be receiving proposals from us for changing some of our antitrust laws, particularly in the international field.

Trade, as the President said last night, that's going to be one of our major drives in 1983, to see that our trade organizations are strengthened here in the United States, that they're well financed through the Export-Import Bank. We even included our ports in that because they need refurbishing in order to be conducive to more international trade.

And the final thing is education. That was one of the things we did stress, that we do need more math, more science. We want to support more of that at the high school level because, as the President stated last night, by the age of 16 if you're not well grounded in science and math you're never going to make an engineer, and I think that that is one of the things that our educators are going to have to come to grips with and then, of course, in the educational field we have the Pell grants and things of that nature. We're not proposing cuts in those for the lower income families and we are going to propose a type of educational fund so that the middle income families can start setting aside money, interest and dividends to be tax-free if used for education.

Representative **Scheuer**. Now a question on the IMF. If you look back to our experience over the last generation since World War II in our international aid, you would have to deduce that it was disappointing, that all of our loans and grants taken together didn't have much of an effect, at least in Sub-Saharan Africa on the population explosion which promises to double their population by the year 2000. It hasn't provided much in the way of human needs for much of the developing world and it hasn't done much to provide jobs in much of the developing world and, after all, the basic human need is employment. They're going to have a deficit between now and the year 2000, according to the World Bank itself, of 650 million jobs which is more than the entire employed population of the developed world.

What do you see within the realm of the possible to induce all of the international financing institutions—not only the IMF but the regional development banks—to try by use of the stick and the carrot to get the developing world and countries to focus their economic development programs more on labor intensive, job producing economic development, on development to meet human needs, and certainly on some kind of holistic program to reduce their population growths. If they continue to double their population every 20 or 25 years there is no way on Earth that they can produce schools and housing and jobs and health facilities to meet that need and all of our efforts in these development programs for health and food and housing and jobs are going to be frustrated by the rate of population growth.

How can we get the international financing agencies to address these problems more effectively than they have?

Secretary **Regan**. Well, that's a broad topic. Financial people usually don't try to get into social questions in granting loans. We try to leave that more to sociologists, politicians, and the like, and try to concentrate on whether the projects are financially sound and whether or not they will pay the returns that they should, not necessarily return in money but a return in human betterment.

As far as the development loans that have been made in the past by the IBRB, I think a lot of them have gone mostly for infrastructure. Enough of that has been done in most countries at this point where I agree with you the emphasis now should be on jobs.

But in saying that, what you mean by jobs is they must produce something that the country can export.

That leads me to the other side of what I wanted to discuss this morning, which is this growing tendency toward protectionism. If we all go protectionist there's no place for these less developed countries to export their products. We have to be sensible and maintain open markets for these people or else there is no hope for them.

So I would hope that as we go through some of our trade measures and look at these things carefully we maintain a careful balance between protecting our own industries and thinking of the needs of the rest of the world.

Representative **Scheuer**. Thank you, Mr. Chairman.

Senator **Jepsen**. Congressman Lungren.

Representative **Lungren**. Thank you, Mr. Chairman. Thank you, Mr. Secretary. I hope you don't mind if I take the subject from population control back to budget control for a second.

Secretary **Regan**. Please do.

Representative **Lungren**. I really appreciated much of what you said in your prepared statement with respect to economic growth. It appears that the administration still believes, as do many of us, that economic growth is the key to our recovery with respect to deficits and interest rates and so forth. However, I'm somewhat concerned about your testimony and the administration's position with respect to their projections of growth for the next year. Although you were applauded by one member of this panel for being more realistic and I can understand why you might be a little gun shy for being perhaps too optimistic in the past. I'm concerned about us being too pessimistic now with respect to your suggestion and the administration's suggestion that the growth that we might see in the economy is only going to be 1.4 percent year over year or 3 percent as you charted it on your chart today, admitting all the while that that's about half of what the postwar recoveries have averaged.

Can you tell me whether your Department has charted what the private forecasters have said? My reading of the private forecasters is that uniformly they're quite a bit above what the administration is suggesting and the reason that is somewhat fearful to me is that pessimistic assumptions might drive the Congress in the direction of increased taxes if we accept those projections. In some ways those overly pessimistic projections could be our own worst enemy and drive us in directions that are very, very different from what the administration is suggesting and what you're suggesting is the policy we ought to follow.

Secretary **Regan**. Let me try to explain. We are below the mean as far as our projections are concerned for 1983 and the early part of 1984. In our projections for the outyears where we're calling for real growth at a rate of 4 percent, which is above the long-term average rate. What we have said is that we think that a lot of the post World War II recessions were cured rather quickly by a large injection of money. Label that inflation. If you notice after each one of the recessions and then the subsequent recovery inflation each time went higher during that recovery period than the previous period. We're trying to avoid that this time and, accordingly, we're not trying to be overly stimulative in the beginning hoping that: First, the recovery will be less inflationary; and second, in the long run it will be more sustainable than this stop and start type of economy, characteristic of the United States over the last 10 years.

Now as far as the private forecasters are concerned, I have looked at the so-called Blue Chip consensus which is 43 different economists or economic forecasting companies. We are fourth from the bottom of the 43. As far as Business Week is concerned, there also we are below the mean.

We based our forecast on the initial flash of minus 2.2 percent for the fourth quarter GNP that was put out by Commerce and made estimates of a noninflationary growth path.

Representative Lungren. One of the concerns I have is the Congress, particularly the House of Representatives, reacts to what the immediate future is and my concern is that if you lowball in terms of making it more pessimistic the projections in the early years, even though you may be more optimistic in the outyears, we may not have reason for optimism in the outyears if Congress responds by enacting counterproductive policy.

We can be concerned about the deficit, as we all are, but it seems to me Milton Friedman has made some sense when he's said that it really doesn't matter in terms of the growth or the health of the private sector whether you take that money away in terms of taxation or you crowd it out in terms of available money that can be borrowed. And my concern is that we turn toward a taxing policy which might cut off the recovery that you seem to believe is upon us.

In that regard, I wonder as far as the contingency is concerned with respect to the tax plan, you mentioned one of them is that the deficit is higher than a certain percentage of gross national product. Could you tell me how that particular figure compares with what we've seen with Japan over the last 10 years?

Secretary Regan. Sure. First of all, let me answer as far as Congress going for tax increases in 1983. As I indicated in answer to previous questions, I think that would be counterproductive. If right at the start of the recovery you suddenly increase taxes or don't give an expected tax cut—it's the same thing—that would simply mean that you're taking away from consumption; you're taking away from savings and the like, to be spent where? In the Federal Government. I think you can reduce these deficits by other means, which is, obviously, cutting Federal spending.

Now as far as the contingency is concerned, we're saying that the tax should be enacted if the deficit is larger than 2.5 percent of gross national product beginning in fiscal 1986, October 1, 1985.

From that point of view, Japan right now has a deficit that is running at nearly 6 percent of gross national product. They are hoping to get it below 5 in the coming year. We are projecting in this current year that our deficit will be about 6.5 percent and next year something in the neighborhood of 5.4 percent.

As far as Germany is concerned, Germany's deficit is about 4 percent of gross national product. Great Britain's is less than that. So in the world we're at the bottom end of the scale as far as our percentages of GNP is concerned.

Representative Lungren. Thank you.

Senator Jepsen. Congressman Hawkins.

Representative Hawkins. Mr. Secretary, I, too, applaud your remarks. Let me follow up on the question of economic growth.

Assuming the projections of economic growth in the neighborhood of 1.4 percent and an increase in the labor force due basically to increasing population which is certainly in that same neighborhood—that is, about 1.5 million—how in the world can you get 10 or 15 million people employed with that type of economic growth? Wouldn't you either have to assume negative productivity or that the employment rate will increase? It just seems to me you're mathematics just don't add up to the rhetoric

Secretary **Regan**. Well, first of all, we are not projecting an increase of 10 to 15 million jobs this year in the economy. We don't think that that can be accomplished even with an average growth of the postwar period.

Representative **Hawkins**. Well, I'm not assuming that. I'm assuming the employment of any number of individuals, your mathematics seem to indicate that the economic growth will not sustain even the increase in the labor force of 1.5 million people per year. That many people will be entering the labor market. So let's assume you've got to prepare jobs for those individuals and you're projecting an economic growth that does not even add up to that number of individuals, and in the meantime you're completely overlooking those that are already unemployed.

Secretary **Regan**. On the contrary, Mr. Hawkins. We are forecasting that the unemployment rate will come down slightly over the course of 1983. We think that is entirely possible with this 1.4 percent growth in GNP even though we don't have a growth in GNP equal always to the growth in the labor supply.

Now over the longer term, I do think that we cannot expect great expansion of jobs, in the heavily industrialized sectors. I don't think growth will be in the steel industry or things of that nature. But I do think they will be in the service industries, particularly in the smaller business. You will recall that a large share of new employment comes from organizations that employ less than 100 people. I don't see a real expansion in the heavy industries over the long run.

Representative **Hawkins**. Well, I agree with you on the nature of the trends. However, we get back to the fundamental question that if you don't have economic growth in the economy, how in the world do you expect to get people employed with negative or low economic growth? The historical growth rate was 4.5 percent up until the present administration and even with that growth rate we had recessions, and now you're talking about a growth rate which is much lower than that and you want to employ these people. I'm not concerned with the question of whether they're employed in the service industries or the basic industries. We're overlooking that for the time being. I agree with your description of where they may be employed, but with this very low economic growth rate, it just seems to me you have an impossible task.

Secretary **Regan**. Well, let's realize how we get that 1.4 percent for the full year. If we start off with a minus 2.5 percent in the final quarter of 1982, we think that this current quarter will be plus. We think by the final quarter of this year real growth rate will be about 4 percent, and that it will continue at that rate. We believe 4 percent is a rate which is sustainable. There are only a few periods that I can recall in post World War II history where there was a sustained growth of larger than 4 percent, the most notable being the period of the early and mid-1960's.

Representative **Hawkins**. Well, I accept your explanation. Stimulation will come in the second half and I hope that it does, but let me get to another question because of the limited time. Why is it that the administration persists in attacking entitlements as if that is the cause of the current recession? Entitlements, as I understand it, are those things for which people are legally entitled by virtue of economic conditions which are beyond their personal control. Now if we didn't have the recession, then obviously entitlements would not be as high as they actually are.

Don't you think it would be much better to attack the high cost of entitlements through putting people to work, through relieving the country of a recession and stop fooling around with freezes on COLA's while at the same time you don t insert a freeze on those individuals who get a tax cut in the higher brackets? If you're going to have some equity, why is it that you ascribe to the entitlements the cause of our difficulties while overlooking the high interest rates and not dealing with the tax structure in such a way that those in the higher brackets accept the same sacrifices as those in the lower brackets? It just seems to me that you have built into the proposal a very unwise social injustice that people complain about and I think rightly so.

Secretary REGAN. Well, again, I'll try to make my answer short. We have never said that the entitlements caused the recession nor do we say that now. We don't believe entitlements have caused the recession. The recession was caused by many other factors.

What we are saying, though, is that growth in entitlements over the past few years has been producing large deficits in this country because we haven't been able to finance them. This, as you know, is the cause of the problem of social service, for example. In social security the actuaries never figured that we would have COLA's that would run 13, 12, or 10 percent in their cost of living. They had, as a result, to restructure the system so that the current workers will have to pay for the benefits that will be received by those who are retiring. We have no reserves now in the social security funds.

Now as far as the tax cut and the fairness of that versus the COLA, I think we're talking almost apples and oranges here because COLA's are primarily for retired people who are taking from the system. People who have gotten pensions from the Federal Government or are part of the social security system. Who's paying for that? The workers are paying for that.

What we have done with the tax cut is to give the workers a break as far as they're concerned, and all we're asking, in fairness to these other people who have received their COLA's more proportionately than wages have risen, is that at this point we hold steady for just 6 months on these cost-of-living adjustments while the rest catch up in the form of a tax cut. I think that's pretty fair.

Representative HAWKINS. Who's paying for the tax breaks for the higher income people?

Secretary REGAN. Nobody pays for that. That would assume that the Federal Government gets all of your paycheck and if they let you have any of it they're paying you to keep your own paycheck. I don't believe in that philosophy. I think that the Federal Government should only tax that much that it needs in order to support certain basic functions. I don't agree that they're entitled to the whole paycheck of any worker in the United States. So we're not paying people when we tax them less.

Now as far as who did this, remember it was the Broadhead amendment that brought the 70 percent down to 50, a Democratic proposal, not ours. In addition to that, we think that the tax cuts that have been made across the board, 5-10-10, are eminently fair for the low income, for the middle income and the high income. Obviously, if you pay more taxes, you're going to get more of a tax break.

Representative **Hawkins**. Thank you.

Senator **Jepsen**. Congressman Wylie.

Representative **Wylie**. Thank you very much, Mr. Chairman.

Mr. Secretary, I apologize for not being here when you started but I had two prior commitments this morning before the hearing was set. I do want to congratulate you for the excellence of your appearance here and for your testimony that I've heard.

May I say that I liked the President s state of the Union message last night. I thought it was very positive and very upbeat. Most of the questions I had from reporters were about the standby tax. In my opening statement, I asked how much strength is there behind the administration's consideration of sweeping tax changes—consumption taxes, flat taxes, or what have you. What can you tell us in that regard, Mr. Secretary.

Secretary **Regan**. Well, what the President has asked me to do is to come up with a budget figure. Obviously, this is not something that is going to be easy to do. As you know, it's a complicated subject. Most people say an actual flat tax is an easy thing to accomplish, but it's a very difficult thing. An actual flat tax, let's say 20-percent flat tax across the board, would mean that anyone at the low end of the scale—these in the 12-, 14-, or 15-percent tax brackets—would have their taxes raised. Those in the higher tax brackets, 30, 40 to 50 percent, would have them brought down to 20 percent. You've got to watch the fairness here on the flat tax.

As far as the consumption tax is concerned, that again gets very complicated. If you tax people just on what they spend, what if they spend savings. Suppose you take savings out of a bank and put it in a new automobile. You're already paid taxes on the money you earned before you got that savings. Now you take it out and spend it on an automobile. It is taxed again. Double taxation on savings. You have to worry about things of that nature. This is a very complicated subject and it's not one that I'm going to come up with a fast answer on.

Representative **Wylie**. It's still in the development stage which is what my answer was last night. You said a little earlier that in your view long-term interest rates are not low enough right now for a sustained recovery. Is that a fair appraisal of what you said?

Secretary **Regan**. That is correct.

Representative **Wylie**. What rates do we have to get to sustain a long-term recovery?

Secretary **Regan**. Single digit.

Representative **Wylie**. Single digit?

Secretary **Regan**. Long-term Treasuries are now at about 10¾ percent. I think if we can get them down below 10 percent and then have them come down even lower so that long-term corporate rates which are currently in the 12- to 13-percent range would come down to single digits, I think that would do it.

Representative **Wylie**. There have been more positive signs as far as short-term rates are concerned, but mortgage interest rates and long-term bond rates are significantly higher, and that's what I had reference to. They have to come down. Is 10 percent a significant barrier?

Secretary **Regan**. It's very significant I think. At 12 percent, mortgages are proving to be very acceptable to quite a few people. That's why housing starts have risen and secondary home sales have snapped back over the past 3 or 4 months. Again, if you could get long-term mortgages in single digits—8 or 9 percent—you really would have a tremendous revival in that market.

Representative **Wylie**. Interest rates are the key to economic recovery, aren't they?

Secretary **Regan**. I believe so.

Representative **Wylie**. There seems to be a perception that when economic recovery begins in some quarters that interest rates will rise again or automatically go up. I've read that. However, I think that's a misconception for several reasons. When economic recovery begins there is an improvement in cash balances, business profits improve, and there isn't much money needed out there in the credit market so there isn't pressure in the credit markets. Do you think that is a valid perception?

Secretary **Regan**. No, I don't think the perception is valid. I think, along with you, that demands for credit in the early stages of recovery are not that great and, accordingly, as long as the Treasury doesn't crowd them out there will be enough money available in the early stages of a recovery. There is no doubt that as more demand comes in and unless the savings pool continually increases, supply and demand would automatically mean that interest rates would rise. They don't have to rise precipitously though. I think what most people are afraid of is that we will go back to 15 or 16 percent rates. I doubt that at any time in the foreseeable future we will see rates that high.

Representative **Wylie**. I hope not. I heard the testimony a little earlier with questions with reference to the IMF and the World Bank and so forth and I want to be in a position of supporting the administration in that regard. Have relatively high interest rates in this country strengthened the dollar in the international markets to the point that it has impaired our ability to export and to have exports in agriculture and manufacturing help economic recovery?

Secretary **Regan**. The short answer is yes. I think that the strong dollar does hurt exports. I think that because of the strong dollar in 1982 we're going to have an unusually large trade deficit in 1983. There's always quite a lag here between the weakening of a currency—as has happened with the dollar since November—and a recovery in trade. So I think that 1983, at least the early part of it, is going to see some large deficits in our trade balances due strictly to the high dollar in relation to other currencies.

Representative **Wylie**. It sounds like we're on the horns of a dilemma. My time is up.

Senator **Jepsen**. Senator Sarbanes.

Senator **Sarbanes**. Mr. Secretary, despite the rhetoric in which it's dressed up, it's an extraordinarily gloomy picture for the economy that you lay out before us.

The first question I want to put follows up something Congressman Lungren asked. Some commentators have suggested that the administration has made a deliberately pessimistic forecast on economic growth in 1983, in order to create the impression that the economy is not doing very well, but is nevertheless doing better than the very pessimistic forecasts, and therefore making it appear that things are moving better than had been anticipated. Is there any basis for that?

Secretary REGAN. No, sir.

Senator SARBANES. All right.

Secretary REGAN. We did not deliberately lowball. There are good sound reasons why we have come up with that forecast.

Senator SARBANES. So you regard this as a realistic forecast?

Secretary REGAN. Cautious, prudent, yes, but realistic.

Senator SARBANES. Now, accepting your forecast, I searched all through your statement and couldn't find it. So we're going to have to try to work at it. What would the unemployment rate be in 1983, accepting your forecast with respect to economic growth?

Secretary REGAN. Excuse me a minute while I look for it, Senator. I have just about everything else.

Senator SARBANES. I know. I looked all through it and couldn't find it.

Secretary REGAN. I'm looking through our forecast. It's not in the President's statement, though; you're correct in that. Let's see, for the year 1983, 10.9 percent unemployment for the civilian labor force, compared to 10.8 percent in December 1982.

Senator SARBANES. So when you say for the year, what does that mean?

Secretary REGAN. Well, the percent for the total year will be 10.9 percent, the final quarter will be 10.6 percent and it starts out at 11 percent in the first quarter.

Senator SARBANES. So you're predicting an unemployment rate of an average rate of 10 percent for 1983?

Secretary REGAN. 10.9 percent to be precise.

Senator SARBANES. For the year figure?

Secretary REGAN. 10.9 percent, yes.

Senator SARBANES. And that's on the assumption of this real growth figure that you're giving us?

Secretary REGAN. That's right, 1.4 percent for the entire year, and 3.1 percent increase from the fourth quarter of 1982 to the fourth quarter of 1983.

Senator SARBANES. It's your view that a 1.4-percent growth rate for the entire year will yield a drop in the unemployment rate to 10 percent for the entire year?

Secretary REGAN. That's correct.

Senator SARBANES. What's your view about a 10-percent unemployment figure?

Secretary REGAN. It's still too high and needs to be brought down.

Senator SARBANES. Much too high, wouldn't you say?

Secretary REGAN. Yes.

Senator SARBANES. Now, about the standby tax that the President talked about to reduce the budget deficits, if necessary: Are the revenues from that tax included in the figures that project the budget deficit of $117 billion in 1988 which the administration has provided?

Secretary REGAN. Yes.

Senator SARBANES. In effect you're including the revenues from the standby tax in your 1988 projections; is that correct?

Secretary REGAN. That's correct because we do not forecast a drop in the deficit below 2.5 percent in fiscal 1986, 1987, or 1988 without the contingency tax.

Senator SARBANES. If the deficit does not drop below those forecasts, would the primary reason be that the economy was soft, would you say, and that recovery had not been achieved at the level that was hoped for?

Secretary REGAN. No. We think the primary reason would be that Federal spending would continue to increase and in those outyears would still be 23 or 24 percent of gross national product with revenues being somewhere around 20.5 percent of GNP.

Senator SARBANES. But the reason for that would be a slow economy?

Secretary REGAN. No. We're projecting 4 percent real growth in those outyears, which is higher than the long-term average growth rate.

Senator SARBANES. What unemployment rate do you project for 1988 which leaves us with those large deficits and has you kicking in the contingency tax?

Secretary REGAN. 6.5 percent, roughly.

Senator SARBANES. You're projecting an unemployment rate of 6.5 percent. What would the budget deficit be if you didn't include the contingency tax?

Secretary REGAN. $160 to $170 billion. That would be, with a gross national product we're projecting, about $4.9 trillion—without the contingency tax the deficit would be about 3½ percent of GNP.

Senator SARBANES. What is the cost on the revenue side of the tax cuts that the President was so insistent upon last night? What is that cost on the revenue side, whose two elements the President was so insistent last night that should not be touched?

Secretary REGAN. The tuition tax credit?

Senator SARBANES. No. The 1983 personal income tax cut and then the indexing thereafter.

Secretary REGAN. The size of those? I don't have those at my fingertips. I take it that you would mean for a full calendar year rather than just the remainder of 1983. Is that what you're referring to, Senator?

Senator SARBANES. No. What I'm really getting at is this: if you had a 6.5-percent unemployment rate in 1988 and those tax cuts did not take effect, what would be the deficit situation?

Secretary REGAN. If we did not have the third year nor indexing?

Senator SARBANES. Nor indexing.

Secretary REGAN. Would you include in that the trigger tax?

Senator SARBANES. Not at the moment.

Secretary REGAN. Not at the moment. It would be higher, I believe. My tax experts tell me that it would be about $70 billion, the effect in 1988 of a repeal of the third year and eliminating indexing for 1986 to 1988.

Senator SARBANES. In other words, the deficit situation would be reduced by $70 billion. Is that correct?

Secretary REGAN. I'm not sure. Your straight arithmetic would say that but you don't know the effects on savings, investment, growth, and the like if you do away with those tax cuts. We have figured them into our growth pattern of 4 percent. If you didn't have those tax cuts, you would have to figure out what your gross national product would be.

Senator SARBANES. Well, Mr. Secretary, my time is up. I just want to make this point. When you appeared before this committee a year ago we had an exchange in which I brought to your attention a very human problem that was occurring not only in my State but all across the country. People are losing their jobs, using up their unemployment benefits, and in the example I gave you people were selling off their home furnishings to try to raise the money to pay their home mortgage. I asked you what should I tell them. I don't know if you recall that.

Secretary **Regan**. I do.

Senator **Sarbanes**. I hope you can think back. And you said, "We—and I'm going to quote you exactly—"Well, first of all, I feel very sorry for anybody in that position. It's a tragic situation. I don't think, though, that a quick fix attempt by the Congress would alleviate it. I think there is hope that our program is going to work and work shortly." I asked, "From my point of view, is there anything we could do, any magic we could exert, any type of congressional type bill that would help in this situation?" "I don't know any. I think at this particular time if the Congress would start now before the program could be put into place it would be August, September, October, and hopefully by that time we will be out of the recession."

What was the unemployment rate then? That's a year ago. I think it was 8.5 percent.

Secretary **Regan**. It was 7.6 the entire year of 1981 and 9.7 for 1982.

Senator **Sarbanes**. In January 1982, when we had this exchange, I think the monthly rate was 8.5 percent. It went to 8.8 percent in February and today it's at 10.8 percent.

Secretary **Regan**. It was for December, yes.

Senator **Sarbanes**. I've not been back to these people. They may well have lost their home by this time. What do we tell them now?

Secretary **Regan**. Well, you can tell them that the Secretary of the Treasury made a mistake, like most economic forecasters, for 1982. I know of no one who thought that the recession would be that bad. As a matter of fact, we were talking earlier about the consensus view of economists in July, just 5 months after my testimony, most economists were still saying we would have the recovery in the fourth quarter, which again was what I was saying in January of last year, but I missed it. I admit I missed it.

In all sincerity, now I think that we have turned the corner and the signs of recovery are here and that we're in the recovery phase.

Senator **Sarbanes**. Do you think there's much hope being held out to people when even under your own projections, you're still assuming that we will have an unemployment rate for 1983 of 10 percent? That's the highest in 40 years.

Secretary **Regan**. That's correct. It's not something that can be brought down that quickly. We are training people for new jobs. We have the new job training program. We are extending unemployment benefits. That's one of the recommendations the President made last night. We are also going to have a voucher system whereby a person on long-term unemployment can buy his way hopefully into a job and we are going to have more in the way of education of people in order that they can find jobs in the areas where there is employment rather than those who have been let go from places that may not rehire them. So I think we're trying to do something about this.

Senator **Sarbanes**. Mr. Chairman, I just want to make one concluding comment on a separate subject.

Mr. Secretary, I am concerned that there was not heavy Treasury involvement in the consultations with the Japanese when they were here. If I'm incorrect in that, I'd like to have information about the very strong Treasury involvement. It's my perception that the difficulty in our economic relationships is enormously compounded by the imbalance in the currency ratios between the dollar and the yen. This was addressed by my colleagues on the other side of the aisle with respect to the strength of the dollar. Many of these pressures that we are concerned about in trade terms reflect the underlying imbalance in the currencies. If in fact the Japanese are getting a 20- to 30-percent price discount because of the currency valuations, obviously it's extremely difficult for us to compete with anybody who has that price discount advantage. I don't have the time now, but I'd be interested to know the extent of Treasury involvement in the discussions and how strongly the currency question was put to the Prime Minister and other officials of Japan when they were in this country.

Senator **Jepsen**. Mr. Secretary, in the interest of time, since I understand you do have an appointment and will have to leave in approximately 15 minutes, do you want to submit your answer in writing for the record?

Senator **Sarbanes**. I think it might be better for the record because it raises the whole question about the lead role of the Treasury in making of economic policy. There have been comments about this. I am concerned that the Treasury is not playing that role to the extent that the Treasury has traditionally played it.

Secretary **Regan**. Let me state for the record right now that the Treasury is playing a lead role in economic policy and will continue to do so. Some former Secretaries have told me I'm playing more of a role than they did. We were quite heavily involved with the Japanese, which I will point out in my submission for the record.

Senator **Sarbanes**. Fine.

[The following information was subsequently supplied for the record:]

THE EXCHANGE RELATIONSHIP BETWEEN THE DOLLAR AND THE YEN

The Treasury Department actively participated in meetings with Prime Minister Nakasone as well as the preparations for these meetings. I met with Prime Minister Nakasone on January 20, 1982. Deputy Secretary McNamar attended President Reagan's meeting with Prime Minister Nakasone and a breakfast for U.S. officials with responsibilities in the economic area hosted by the Prime Minister. The issue of the yen/dollar relationship was discussed with Prime Minister Nakasone. I would like to add that Treasury officials have also discussed exchange market matters and the yen/dollar relationship on numerous occasions with Japanese Finance Ministry officials.

The Treasury Department has also played the major role in formulating the Administration's position regarding the relationship between the dollar and the yen and in explaining our views on this issue to the U.S. business community on numerous occasions. Key events in our consideration have been:

August 12, 1982.—Treasury Under Secretary Sprinkel met with delegation of U.S. businessmen led by Alexander Trowbridge, President of the National Association of Manufacturers.

October 1, 1982.—Under Secretary Sprinkel testified before the House Ways and Means Subcommittee on Trade on the yen/dollar relationship.

October 27, 1982.—I chaired a meeting of the Cabinet Council on Economic Affairs to discuss issues raised by the Japanese yen's exchange rate and Japan's financial market restrictions.

October 28, 1982.—Together with several other Cabinet officials, I met with a delegation of top U.S. corporate CEOs at the White House.

November 30, 1982.—Under Secretary Sprinkel again submitted testimony to the House Ways and Means Subcommittee on Trade on the yen/dollar relationship.

At present, the Senate Foreign Relations Committee has asked the GAO to conduct a study of the yen/dollar relationship. Treasury staff has closely cooperated with GAO staff in providing analysis and information.

Let me briefly review for the record our analysis of the yen/dollar relationship and the policy conclusions we have reached from our analysis.

ANALYSIS

Developments in the yen/dollar exchange rate are not unique. In recent years, the dollar has appreciated against all major currencies, and by larger amounts than against the yen.

In addition to generalized dollar strength, there are factors specific to Japan which have contributed to the yen's depreciation: weaker Japanese external performance than previously anticipated, including declining Japanese export volume—due partly to Japanese export restraints and protectionist pressures which lower market expectations of future Japanese export earnings—and large net capital outflows from Japan, reflecting a Japanese propensity to export capital in view of Japan's high domestic savings rate.

Japan has made substantial progress in internationalizing its financial system in recent years as shown by the sizeable growth of capital flows in and out of Japan. A consequence of greater foreign access to Japan's capital markets, at least in the short term, is downward pressure on the yen and this has also been a factor in the yen's weakness.

We have looked at the situation closely and found no evidence to support allegations that the Japanese authorities are manipulating markets to weaken the yen. A review of Japan's macroeconomic policy objectives, foreign exchange market intervention, and efforts to maintain short-term interest rates at levels higher than desired in view of domestic economic considerations suggests that the Japanese authorities seek a stronger yen.

Over the long term, changes in exchange rates can be expected to reflect relative price movements. But purchasing power parity measures, which some cite as demonstrating the existence of an undervalued yen, are not a useful guide to the "correctness" of exchange rates. At any particular time, many factors can—and should—influence exchange rates in the near term.

POLICY CONCLUSIONS

First, we should continue to press Japan to liberalize and internationalize its financial system, even though liberalization could tend to weaken the yen in the short term. A liberal environment for international investment flows is in our interest, in Japan's and that of the world at large. The United States should not urge Japan to impose controls on capital outflows in an effort to strengthen the yen.

Second, we should not press Japan to reorient its fiscal and monetary policies toward relaxing efforts to control budget deficits and raising Japanese interest rates. The Japanese budget deficit is presently about 5½ percent of GNP. The Japanese authorities want to cut fiscal deficits and the growth in government expenditures. These are the same fiscal objectives this Administration is pursuing.

Third, we should not argue that Japan should have an exchange rate target or intervene more in the markets in an effort to strengthen the yen. The foreign exchange markets are too big to direct, control or manipulate in any lasting sense, and we believe that the judgment of the marketplace about exchange rates is superior to that of government officials.

Fourth, we should strongly oppose suggestions that the United States impose a variable import duty on United States imports from Japan or other nations which some allege to have "undervalued" currencies. Such action would be flatly protectionist and would represent not only a serious violation of the GATT principle of most-favored-nation treatment, but a serious departure from the historic U.S. commitment to free trade.

Senator **Jepsen**. Senator Mattingly.

Senator **Mattingly**. It's good to see you again, Mr. Secretary. One response you may want to give the next time when you go back to tell your constituents, you can tell them that you didn't vote the U.S. Congress in. Congress is the one who's been fooling around with this budget over here. I don't think it was you that voted the increase that we had. That may be told. I think that we are all looking for growth in our country and current economic recovery and want it to happen tomorrow morning at 8 o'clock, but I think realistically we know that's not going to happen.

I think in looking at the international situation that we also understand the United States is probably going to pull the rest of the world along. Now there's a lot of factors you could go into. You know better than I do what's going to turn the key, whether it be taxes, budget, regulatory, trade—I won't get into the off-budget items because that would take too long a time to debate anyhow. I think we ought to stop worrying about where we are going to tax this country and I think get down to one of the things that I think was brought out in the speech last night and it gets back to what I was saying about the Congress and the budget, and that is the budget. I would like to have your opinion on something and that is the freeze.

Now I listened to the President last night talking about how he felt as he approached the budget and the tax freeze. As he was talking about it, I felt this was basically a small first step, because I think that here in just a few minutes, I will drop my own legislation off about an across-the-board freeze. There would be no exclusions other than interest on the national debt and new annuities under the system—to freeze the fiscal year 1984 budget at the fiscal year 1983 level. I don't see any other way to get the Government out of the borrowing business so the private sector can get in there and also to stifle this growth of the Federal budget that we have.

I would like to have your opinion on that and especially from the fairness point of view about an across-the-board freeze. I think in the long haul, once we look at both the social security program and all other programs that if you're going to freeze for 1 year—you would freeze everything for 1 year, everybody, every program would be frozen for 1 year—and wouldn't that be more fair and equitable and reasonable?

Secretary **Regan**. What the President was proposing last night and will propose to the Congress is that spending in 1984 not exceed the rate of inflation, approximately 4.5 percent. That is for the overall budget. But inside the budget there would be some programs that would be cut, some that would remain at the same level and a few would be increased. When we talk in terms of the budget we have to remember there are budget authorities and some of these previous budget authorities called for increased outlays, particularly, for example, in defense in 1984 over 1983. It may be difficult to freeze outlays that have already been committed for which materials are in the process of being manufactured.

Senator **Mattingly**. Let me inject something. What I'm saying is we don't want to complicate freezing. This is not complicated. I'm not saying you're complicating it. I think we will hear a lot of bureaucrats saying it's complicated, but don't you feel that if a freeze—

I'm not saying what I'm proposing is the final answer, but it would force change in those agencies, whether it be a Defense Department or a HUD or whatever it might be out there that would never occur unless you did have a freeze.

Secretary REGAN. Well, I think you have to somehow or other stop their growth, yes.

Senator MATTINGLY. And let me say it one more time, and as one of the leaders, I'm sure you feel sometimes the tail is wagging the dog and it does up here——

Secretary REGAN. Well, there's no doubt, as I said in answer to a previous question, that payments to individuals has grown as a portion of the budget over the last decade. In the time of Lyndon Johnson they were about 5 percent of the gross national product. They are now up to over 12 percent of gross national product. I think they have to be cut back where we do take care of the truly needy. There's no doubt in my mind that there are areas in which Federal aid is a necessity, but at the same time I think we have to be careful of any number of programs in the educational field, for example, where we have continually expanded and expanded and expanded. I think we have to cut back.

Senator MATTINGLY. You feel any program like that where every recipient—if everybody knew they were all not getting less but all going to be frozen in place rather than this one being frozen at this level and this one being frozen at that level and this one over here at another.

Secretary REGAN. We tried to put a symmetry in, following the bipartisan approach to the social security legislation——

Senator MATTINGLY. I don't mean just the social security.

Secretary REGAN. Which would freeze the COLA for 6 months. If you try to get beyond 6 months to a year in programs that are analogous to social security—Federal retirement, veterans, things of that nature—you lose the symmetry.

Senator MATTINGLY. I got my notice here but I would like as the questions go on if you don't get to my question, you don't have to answer it here, but later, but the trade protectionism that you have brought up, the strong dollar that was the reason for trade declining. Let's not deceive ourselves and say that's the reason why our trade went down.

Secretary REGAN. That was one of the contributing causes.

Senator MATTINGLY. But our trade was down too because we were sitting over here free trading and nobody out there was free trading and what we're trying to do is create some fair trade and I think when the IMF comes before a lot of these committees and says would you be willing to accept some conditions on the IMF, sure, if the IMF is going to dole out money we all should be treated equally and fairly out there. My 5 minutes are up. You can write that answer. Thank you.

[The following information was subsequently supplied for the record:]

1. The IMF does help to restrain protectionist pressures and to promote a more open international trading system.

2. For example, a standard performance criterion in IMF programs is the prohibition on new or intensified restrictions on payments for current transactions. In this context, a member is prohibited from making drawings under a program if it:

(i) imposes new or intensifies existing restrictions on payments and transfers for current international transactions, or

(ii) introduces or modifies multiple currency practices, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

3. We will be considering possible additional steps that might be taken to strengthen the IMF's ability to encourage an open international trading system.

Senator JEPSEN. The Chair advises the committee that we do have 4 minutes left. Is there any committee member who wants to ask a followup question?

Representative LUNGREN. I just have one followup question. The reason I was asking about Japan and their percentage of deficits to GNP has been substantially higher than the target you have for triggering the contingency. My question is. Why in the light of the tremendous, at least heretofore, expansion of the Japanese economy, their lower interest rates, their lower unemployment rates, and their higher growth rates, would we be triggering something that seems to go against the historical experience of Japan with respect to the size of their deficit as a percentage of GNP?

Secretary REGAN. I think it's because the Japanese saving rate is so much higher than ours. They have a much larger pool of capital available to accommodate those large deficits without risk monetizing. With our small percentage of savings that we run the risk of monetizing if we continue to have these large deficits.

Representative LUNGREN. And that's why the taxing policy is so extremely important that we do nothing that would discourage the entry into the savings market that we see people beginning to participate in.

Secretary REGAN. I agree with you completely on that.

Senator JEPSEN. Thank you, Mr. Secretary. The committee will now stand in recess until tomorrow morning.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, January 27, 1983.]

THE 1983 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, JANUARY 27, 1983

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Roth, Proxmire, Kennedy, and Sarbanes; and Representatives Hamilton, Long, Wylie, Holt, and Snowe.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; Richard F. Kaufman, assistant director-general counsel; and Louis C. Krauthoff II, Marian Malashevich, Mark R. Policinski, and George R. Tyler, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Chairman Volcker, it's always a pleasure to welcome you to the Joint Economic Committee. I am particularly eager to hear your comments today because monetary policy has never been more crucial to the performance of the economy than it is today.

Almost all economic forecasters believe we are now in an economic recovery. And most believe, though it won't set any records, the recovery will be surprisingly stronger than anticipated a few months ago.

But the American public is uncertain about what will happen to the economy over the next year or so. We see this uncertainty everywhere we go. Among the uncertainty, business is reluctant to invest in expansion, workers are confused by the chances of layoffs or callbacks, and farmers do not know how much it will cost them to finance their next crop.

And if there is one item in the economy that is the basis for the public's uncertainty it is interest rates. The reason for the confusion about interest rates is quite simple: The average person hears that interest rates, like the prime rate or T-bill rate, have fallen for the past 2 years, but they don't see it in their own lives.

For example, in my part of the country, the latest figures available show that feed cattle loans are almost 16.5 percent and real estate loans for farms are 16.16 percent. Another example is right here on Capitol Hill at the U.S. Senate Credit Union where a signature loan is still 16 percent.

Interest rates are an unsolvable puzzle to most Americans. And I think the Federal Reserve policies are also an enigma to most Americans. I must say that I find that quite strange; that something as important as monetary policy is not understood by most of the people.

While that may be strange in normal times, I think it is a threatening position to the Fed when interest rates are so high for so long. People will blame the Fed for these high interest rates until the Fed takes steps to better explain its policies to the American people. Let me be clear. I think the independence of the Fed is at stake. I hope that the Fed will go to great lengths to specifically explain, beyond a shadow of a doubt and with straight talk, what it is going to do in the next few months and the next year to lower interest rates.

And while you are at it, Mr. Chairman, I hope you will clear up something I am having trouble understanding. Since July, M_1 has grown by $33 billion, about 16 percent at an annual rate. During the last quarter of the year, consumer installment debt fell dramatically. And yet, even with this dramatic growth in the money supply and decline in consumer demand for credit, interest rates have risen slightly since October. Are these higher interest rates due to greater demand for credit by government or are they due to an increase in inflationary expectation caused by the large growth in the money supply?

Chairman Volcker, I thank you for coming today to help this committee. This probably will be the single most important meeting that will take place in the launching of this Congress if this Congress and this country better understands the Federal Reserve policy.

Now I yield to the Congressman from Indiana, Congressman Hamilton.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

Representative HAMILTON. Thank you very much, Mr. Chairman. We join you in welcoming Chairman Volcker to the committee this morning. Let me just add this one thought: Last December in the continuing resolution the Congress directed the Federal Reserve to achieve and maintain interest rates low enough to bring about sustained economic growth and to lower unemployment. So I think one of our chief interests, perhaps the chief interest, this morning, Mr. Chairman, will be to see what plans the Federal Reserve has to bring about that objective. Thank you very much, Mr. Chairman.

Senator JEPSEN. Congressman Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you very much, Mr. Chairman.

I would like to join in welcoming you, Federal Reserve Board Chairman Volcker, to these hearings this morning.

I feel strongly that Chairman Volcker deserves a lot of credit for his performance over the last few years. Though it's always easy to criticize the Fed, I think under your leadership, the inflation rate has been brought down faster than most people thought possible.

In 1980, for example, the CPI increased at a rate of 12.4 percent; in 1982 it rose only at a rate of 3.9 percent. While some of the Fed's operations may have been less than perfect, on the whole I think they have been pretty successful, Mr. Chairman, and I want to applaud you.

Furthermore, the reduction of inflationary expectations has led to a dramatic fall in interest rates. The prime rate which stood at 21.5 percent in early 1981 is now at 11 percent, about half of its previous high. Long-term rates have dropped substantially. Although all agree that interest rates still are much too high, at least I feel under the long-term policy of monetary restraint they have been helped to decline.

It would be unfortunate if political pressures encouraged a recurrence to monetary expansion with the resultant rise in the rates of interest and inflation, a renewal of inflation will only make our problems much worse. Over the past 6 months, M_1 monetary base and total reserves have all expanded rapidly. M_1 is now increasing at a rate approaching 20 percent on an annual basis. I hope this does not signal a retreat from the Fed's policy of monetary control. If inflationary expectations are revived, we may well see higher interest rates in the coming months. This could easily choke off the fragile economic recovery and shatter the hopes of our people for better times ahead.

Mr. Volcker, we welcome you to this hearing this morning and look forward to your testimony.

Senator JEPSEN. Senator Kennedy.

Senator KENNEDY. I have no statement, Mr. Chairman. I just welcome Chairman Volcker.

Senator JEPSEN. Senator Roth.

Senator ROTH. I, too, welcome Chairman Volcker, but I have no statement.

Senator JEPSEN. Congressman Long.

Representative LONG. No statement, Mr. Chairman. I welcome Mr. Volcker.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. I have no statement, Mr. Chairman.

Senator JEPSEN. Senator Proxmire.

Senator PROXMIRE. No statement.

Senator JEPSEN. Congresswomen Holt.

Representative HOLT. No statement, Mr. Chairman.

Senator JEPSEN. I have an opening statement from Senator Abdnor that I will insert in the hearing record at this point, without objection.

[The opening statement of Senator Abdnor follows:]

OPENING STATEMENT OF SENATOR ABDNOR

Welcome, Mr. Volcker, I take this opportunity again—as I did a year ago during this committee's annual hearings—to relate to you, Mr. Chairman, the continuing economic plight of American farmers. According to the Department of Agriculture, 1983 will mark the 4th consecutive year of declining and record-low farm net income. The agriculture sector is being crippled by global as well as domestic recession. South Dakota farm and ranch bankruptcies, almost all of them sole proprietorships, almost quadrupled during 1982 compared to 1981.

However, there was a bright light during 1982—the inflation rate of farm input costs rose less than 2 percent. Had farm production costs increased at the same pace during 1982 as they did in 1981, farm net income would have been $12 billion rather than $19 billion. Mr. Volcker, if there is one figure I would like you to take from this hearing it is this one: for every 1 percent increase in the inflation rate for farm inputs, farm net income declines approximately $1.4 billion. And when you are working from a base of between $15 and $19 billion, it doesn't take much of an increase in inflation to dramatically reduce farm net income. Should the rate of inflation associated with farm inputs go to but 3 percent in 1983 and all other things remain unchanged, farm net income could be cut 10 percent.

This is why I am so concerned, Mr. Chairman, with the speculation that recent actions of the Federal Reserve Relative to the growth in the money supply may reinflate the economy. With little or no prospect for significant improvement in farm revenues, even moderate cost increases in farm production items would seriously, and perhaps permanently, endanger this country's food and fiber production capabilities. The consequences of that event to the world, as well as to the U.S. economy, are indeed devastating.

Senator JEPSEN. With that, again, welcome—is Governor the proper title?

Mr. VOLCKER. I'm a Governor and I'm the Chairman of the Board of Governors, so I've got two titles I suppose, Mr. Chairman.

Senator JEPSEN. All right. Well, you may proceed, Governor and Mr. Chairman.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I appreciate the opportunity to appear before this Committee today. In about 3 weeks, the Federal Reserve will submit its semiannual monetary policy report to Congress. At that time, I will be reporting on the details of monetary policy, including the Federal Reserve's objectives for the growth of money and credit over the period ahead. This morning I will confine my statement to more general considerations of domestic and international economic policies within the context of recent and prospective developments.

The past year and a half has been a difficult period in the Nation's economic history. Output has contracted, too much of our industrial capacity lies idle, and unemployment is far too high—the highest since World War II. But as we enter the new year, there are encouraging signs that recessionary pressures in some key sectors are abating. Substantial progress has been made in reversing the inflationary trend of the past decade, and we can build on that progress. Of central importance to that outlook are signs that productivity may be growing more rapidly after a decade of increasingly unsatisfactory performance. Consequently, the stage appears set for sustainable recovery in business activity, bringing with it the higher levels of employment and real income that we all desire. The challenge for policy is to make that prospect a reality that can carry forward for many years.

An important element in this improved outlook is the change in financial market conditions over the past year. Federal Reserve policy has been aimed at avoiding monetary excesses that would lead to resurgent inflation, while providing enough liquidity to meet the needs of economic growth. In the midst of rapidly changing economic and financial conditions, meeting this objective could not be a simple mechanical matter of adhering rigidly to a preset guideline for money and credit growth. At times in the past year there have been indications of unusual demands for highly liquid assets, evidently reflecting shifting preferences on the part of the public in an environment of uncertainty. Moreover, the monetary aggregates, particularly in the latter part of the year, have been distorted by a sequence of special developments—most prominently, the maturing of all-savers certificates and the introduction of new deposit instruments.

These and other influences resulted in extraordinary decreases in the observed velocity of money—loosely speaking, the "turnover" of money balances. In fact, velocity has declined to an extent without precedent in the postwar period. We thus have had to approach monetary targeting and our operational decisions to provide reserves with greater elements of judgment and flexibility in the light of emerging developments. There has been a need to take account of the possibility that underlying trends in the relationship between measures of "money" and economic activity may be shifting as inflation and market interest rates decline while, to a greatly increased extent, market-oriented interest rates are paid on bank deposits. In the end, we accepted some "overshooting" of the ranges we set for monetary growth—relatively small for the broader aggregates M_2 and M_3, and sizable for M_1.

A number of factors, including the halving of the inflation rate during 1982 and the recession, contributed to substantial declines in nominal interest rates all along the maturity spectrum in the second half of the year. Short-term interest rates are now as much as 10 percentage points below their earlier peaks, and long-term rates are down 5 to 7 percentage points. Meanwhile, equity prices have risen sharply.

Lower interest rates for mortgages and—to a lesser degree—for installment credit have helped make the financing of purchases by households more affordable. At the same time, businesses could begin to improve their balance sheet positions. Bond issuance by nonfinancial corporations in recent months has more than tripled from levels in early 1982 as corporations have been refunding short-term debt.

Reflecting these developments, activity has been improving for some months in the credit-sensitive housing and consumer durables sectors of the economy. The most notable turnaround has been in real estate markets. Construction of new single-family homes is up a third from last summer's very low levels and sales of new and existing homes have climbed substantially. Housing activity is still, of course, well below earlier peak rates, and below what we would like to see over time in order to insure that our growing population can be well housed; but the inventory of unsold new homes is quite low and the improved financial climate bodes well for further gains in this sector. With personal disposable income relatively well maintained, with some improvement in the liquidity and debt position of consumers, and with much more moderate price increases, consumer purchases of "big ticket" items also appear to be stabilizing or improving.

The short-term business outlook is often dominated by inventory adjustments, and 1983 may be no exception. Recalling the excesses of earlier recessions and faced with high borrowing charges, businesses made vigorous attempts to curtail the accumulation of unwanted stocks late last year. The process moved more unevenly over the summer as sales were disappointing, but picked up in the final quarter. Further liquidation would restrain production growth in the months immediately ahead, but any sustained improvement in final demand could soon be reflected in more than proportionate increases in output.

As production begins rising, we are likely to see more substantial increases in productivity. In fact, productivity grew in 1982, unusual during a period of recession. Widely reported efforts of businessmen and workers to increase efficiency and reduce "break-even" points should pay off more visibly during a period of expansion. Combined with continued moderation in nominal wage increases, such an increase in productivity would imply relatively modest increases in unit labor costs—about two-thirds of all costs in the economy—and thus prolong and reinforce the progress on inflation.

For the time being, with excess capacity large and profits depressed, business investment in new plant and equipment is likely to continue to fall. Some delay in the recovery of capital spending is not out of line with previous cyclical experience, as businesses initially boost operating rates for existing capital rather than invest in new plant and equipment. But it is critical to the long-run health of the economy that a recovery in business fixed investment not be postponed too long. Capital spending has a pivotal role in extending the length and durability of an economic expansion, and in improving productivity and living standards.

The outlook for business fixed investment is in good measure dependent upon renewed profits and recovery, but also on a sense that monetary and fiscal policies will succeed in fostering a more stable financial and economic climate over time. During a period of transition toward price stability, some investment plans based in part on expectations of rising prices may be cut back, particularly if financial market conditions are slow to reflect the progress toward stability. Cutbacks in some sectors of the energy industry in 1982 may be a case in point. One important factor affecting the financial climate and business confidence today is concern about Federal budget deficits and their effects on the cost and availability of funds needed to finance private sector investment. This is a point I will return to later.

The deficit also contributes to uncertainty about whether the gains against inflation can be sustained. By all the various measures, prices rose by 5 percent or less last year, the slowest rate of increase in a decade. To be sure, part of that improvement reflected favorable food and energy price developments, abnormally low commodity prices generally, the effects of the sharp appreciation of the dollar, and more generally, the cyclical weakness of the economy. Obviously, we are still short of the goal of reasonable price stability. In fact, inflation is really only back to the pace of 1971, which was judged to be so intolerable at that time that wage and price controls were imposed, and the American people—habituated to high and rising rates of inflation for a decade—remain skeptical about whether the progress will be lasting.

Unlike 1971, however—in fact, unlike the entire decade of the seventies—trends of underlying costs and inflation expectations are now moving in a favorable direction. I believe this improvement can be sustainable as the economy recovers its upward momentum. I alluded earlier to the favorable signs with respect to productivity. At the same time, increases in nominal wage and salary costs slowed to the 6- to 7-percent range—a development that was fully consistent with maintaining real incomes of workers because price increases were slowing more rapidly than wages.

Clearly, the more restrained wage increases were directly related to the pressures in labor markets during the recession. Total employment fell. While layoffs were concentrated in the industrial sector of the economy, even the service-producing sector—the primary source of employment growth in recent years—experienced declining payrolls. The overall jobless rate reached a postwar high of nearly 11 percent in December, more than 3 perecntage points above the rate that prevailed before the current contraction began.

Obviously, success in dealing with inflation cannot be based on an economy that stays in recession, with all the hardship and misery that implies. We need to maintain moderation in wage settlements and pricing policies as the economy expands. In the near term, the slack in the economy and the present momentum in wages and prices should be consistent with continuing restraint on unit labor costs. But sustained improvement will also depend on a sense of conviction that prices will remain under control, and on prospects for rising real income even as nominal income grows more slowly. Bargaining practices and attitudes—built up during a period of accelerating inflation—change only slowly, but surely success will fundamentally be dependent upon a sense that the financial environment will remain conducive to progress against inflation. The implications for both monetary and fiscal policy seem to me clear.

Other countries have been attempting to deal with some of the same basic problems that we have been facing. After a decade of inflation, subnormal economic performance has been pervasive, and unemployment in the industrialized world has risen to levels unprecedented in the postwar period. The abrupt and disturbing increases in oil prices have certainly been an important influence, first in aggravating the inflation, and then in the subsequent dislocation attendant upon the efforts of almost all countries to contain that inflation by restraining demand. But the stubborn inflationary pressures that arose in nearly all countries cannot be attributed to oil alone, and there was, de facto, a broad consensus that policies needed to be directed toward restoring stability.

While wide divergences remain among individual countries, striking progress has by now been made generally in achieving lower rates of inflation. But, at the same time, growth has essentially stopped, with real GNP in major foreign industrial countries showing no significant change on average last year—on a fourth-quarter to fourth-quarter basis. For most developing countries, there was an abrupt and substantial deceleration from the growth rates of recent years, from about 4 to 5 percent in 1979–80 to an estimated 1½ percent last year. In Latin America, growth apparently was negative.

There has been a substantial risk in this situation of recession feeding upon itself internationally and countries turning toward protectionism in an attempt to insulate their own industries. That approach would, of course, be self-defeating. As protectionist measures spread from one country to another, gains from reduced imports would be offset by closed export markets. At the same time, protectionist measures work directly against the competition necessary to restrain inflation. In the United States, as elsewhere, compromises have been made with protectionist pressures. Nonetheless, we can take some satisfaction from the fact that a liberal trading order has not broken down over all. Maintenance of that approach, which has been a cornerstone of our prosperity for a generation, seems to me critical to the outlook.

Our own vulnerability to weakness in international trade has been conclusively illustrated by events in 1982. The slowdown in business activity abroad, combined with a surge in the strength of the dollar relative to other currencies, has sharply curtailed our export opportunities—and merchandise exports now account for some 16 percent of all U.S. goods output.

From the beginning of the dollar's upsurge in the fall of 1980 through November 1982, the average value of the dollar against other major currencies rose more than 40 percent; it has given up only a limited portion of that rise over the past couple of months. Some of that strength was a reflection of the progress against inflation, and greater confidence in the price outlook is, of course, healthy. The United States was also in a relatively strong current account position in 1980 and 1981 and continuing into the first half of 1982, when some other major countries were running large deficits. However, in 1982 the dollar may also have been unusually strengthened by more temporary, and even noneconomic factors. For much of the period our interest rates were exceptionally high, and the apparent strength, stability, and security of the United States and of its financial system at a time of widespread financial pressures and political and economic uncertainty abroad played a role.

Under the combined impact of world recession and an exceptionally strong dollar, our export volume dropped about 15 percent from the fourth quarter of 1981 to the fourth quarter of 1982, considerably greater than the declines experienced by other industrial countries. While imports have also declined, the change was small. As a result, the decline in real U.S. exports of goods and services during the recession has been equal to nearly one-half of the total decline in U.S. GNP. In contrast to earlier periods of U.S. recession, when our trade balance generally improved thus tending to offset other areas of weakness, the export sector has been one of the major depressing influences on the U.S. economy. While the dollar has lost some of the earlier gains in recent months as our current account has moved into large deficit, the external sector is likely to remain a source of weakness for some time.

The simple fact is that the health of the international economy and our trading position are today highly important to our recovery and prosperity. The point is emphasized all the more by the sharply deteriorated financial position of several large developing countries, countries heavily indebted to commercial banks and other institutions in the industrialized world.

For several years, a number of large developing countries had been increasing their foreign debts at a pace that could not be sustained indefinitely, either from the standpoint of the rising debt service burden on the borrower or of the gradually increasing exposure relative to assets and capital of the lending banks. For a time, the heavy borrowing helped to sustain rapid internal growth in much of the developing world, but increasingly the need for adjustment to reduce internal pressures and balance of payments deficits became apparent. Some of the borrowers started that process some time ago, but with inadequate force and conviction.

The slowdown in world growth helped expose the increasingly precarious position of borrowers as prices of commodity exports fell, markets for manufactured goods weakened, and higher real interest rates increased their debt servicing requirements. The difficulties experienced by our Mexican neighbors—the largest of the international borrowers—in maintaining their debt payments last summer precipitated widespread public awareness and concern about the potential repercussions for the international financial system. The problems are not unique to Mexico, or to banks located in the United States. Without action to deal with these problems, the consequences could be harsh, not only for the borrowing countries but for their trading partners and for all countries dependent upon a smoothly functioning financial system. But the fact is vigorous efforts are underway to deal with the problem. With the active cooperation of the borrowers, the lenders, and the lending countries, they can be successfully resolved.

A basic element in any program must be strong actions by the borrowing countries themselves to restore internal and external equilibrium. It is particularly encouraging that a number of important developing countries have taken the significant step of negotiating comprehensive stabilization programs with the International Monetary Fund. Upon approving such a program, the IMF itself provides limited sums of medium-term financing; even more important, IMF imprimatur should reinforce the confidence of other lenders. In some instances, governments, acting bilaterally or through the Bank for International Settlements, have provided temporary financing to meet pressing liquidity needs as the IMF program is established.

On that base, commercial banks have acted together in important instances to "roll over" existing indebtedness and to assure enough additional funding to permit time for orderly adjustment. Those efforts, involving hundreds of banks here and abroad, typically call for a reduced flow of new bank loans, commensurate with reduced payment deficits by the borrowers, and no increase in bank exposure relative to capital. Well conceived and constructed, the net result of the adjustment and refinancing programs should be to improve the creditworthiness of the country concerned.

All of this emphasizes the key role of the IMF in the international financing system. But if the Fund is to play the strong role required, currently and prospectively, it is essential that it be able to look forward with confidence to enough resources to meet potential demands upon it. Much progress has been made in reaching an international consensus in the discussions about enlarging the resources of the IMF, and agreement on a substantial augmentation of those resources by means of increased IMF quotas and a broadened IMF borrowing arrangement is expected in February. That program will require legislative approval, and I believe timely action by the Congress is essential to assure that IMF resources are commensurate with possible needs and, more broadly, to demonstrate that governments can act together, decisively and effectively, to deal with potential threats to our prosperity arising from international debt problems. Conversely, failure to strengthen the international financial system could only feed back adversely on our own prospects for growth.

All of this implies intense and continuing efforts by the borrowers to expand exports and reduce imports, with implications for the

United States and other leading trading countries. Clearly, we cannot all increase exports and reduce imports together, and it is equally clear that the whole process will be—and over time must be—facilitated by renewed growth in the industrial world. As understated in the communique issued following the January 18 meeting of the Group of Ten, "a sustainable improvement in activity in the industrialized countries in 1983 can make an important contribution to a lasting solution of the indebtedness problem of many developing countries."

I would emphasize the word "sustainable" in that communique. A short-lived recovery, without staying power and accompanied by reignition of inflationary pressures, offers no real solution to our problems or those of developing countries.

It is in that context that I believe we need to approach domestic policy. There was a time when the American public felt confident about the ability of government to improve economic conditions. But long years of accelerating inflation and rising unemployment, instability in financial markets and the economy, and concern about burgeoning budgetary deficits have eroded that confidence. It can be restored, and I am convinced the economy can be returned to a path of sustained growth. But that effort must rest in part on a demonstrated commitment to discplined financial policies.

As we look ahead, and as the President has emphasized, the state of the Federal budget, as it now stands under current law and policies, could undermine that effort. To be sure, a substantial part of the deficits in the 1982 and 1983 fiscal years—certainly more than half—reflects the impact of current business conditions on the budget. Those cyclically induced deficits are not my main concern—indeed they currently help support spendable income and buoy the economy.

In the past as the economy recovered, the cyclical component of the deficit would diminish and the budget would move toward balance. What is unprecedented about the current situation—and is of great concern—is that even as revenues benefit from an expanding economy over the coming years, we will still face continuing sizable deficits unless significant action is taken.

There can be disagreement about the precise size of the prospective deficits: what does seem beyond dispute is that little improvement, if any, in the budgetary position will develop under current law and policies even with a strong and continuing recovery. A number of the proposals of the President in his state of the Union address were, of course, directed toward this problem.

Left unattended, the situation would pose a strong potential for a clash between the need to finance the deficit and the rising financial requirements for housing and the business investment that is crucial to a healthy recovery. In the end, all those needs have to be met out of saving, and there simply isn't enough to go around. The Federal Government will have to bid funds away from potential private borrowers, and the higher real interest rates that result will work against growth in private investment and housing.

It's not just a problem for the future. The perception that there is a major structural imbalance between our spending programs and our revenue base affects financial markets today. Lenders, fearful of renewed inflation and the high interest rates that budget deficits would produce in a growing economy, are more reluctant to commit funds for a long period of time now. The sensitivity extends beyond financial markets because inflationary concerns affect the climate of wage bargaining and pricing policies.

It is tempting to suggest that the budget problem and its consequences for the performance of the economy could be solved by monetary policy. But excessive money and credit creation to meet the needs of the Government would only risk adding to the uncertainty about future inflation and interest rates. In the end, nothing real would be gained, while hard-fought ground in the battle against inflation would be jeopardized.

Certainly a better fiscal outlook—with all it implies—would provide a better environment for the conduct of monetary policy, relieving concern about the longer term implications of every twist and turn in the monetary aggregates or short-term policy actions. But as things stand, fear of growing deficits clouds the future and contributes to market pressures and inflationary uncertainties, adding to the burdens on monetary policy. Conversely, meaningful action to demonstrate the Government's economic discipline on the fiscal side would reinforce confidence that monetary policy over the years ahead can do its job, without intolerable market pressures, in maintaining a course consistent with price stability.

As I indicated at the outset, I will be able to deal more specifically with our targets for the growth of money and credit after the Federal Open Market Committee, in the normal course, meets in early February to adopt guidelines for the coming year. In approaching those specifics, we are, and will continue to be, concerned with maintaining a monetary environment consistent both with continuing progress against inflation and with lasting expansion. Reconciling those goals, at a time when institutional and economic factors have called into question the reliability of past relationships between money and the economy will be a difficult and delicate job. The approach cannot be reduced to an arithmetic, or econometric, formula, nor can success be achieved by monetary policy alone. But I am also convinced that those goals of growth and stability are not inconsistent as we look ahead in 1983. Indeed, I believe that neglect of one of them would, sooner or later, jeopardize the other.

I am also acutely aware that the recent gains against inflation have been achieved in a context of serious economic hardship. The present state of affairs must not continue. Millions of workers are unemployed, many businesses are hardpressed to maintain profitability, and business bankruptcies are at a postwar high. But in coping with inflation I also firmly believe we have laid much of the foundation for a long period of noninflationary economic expansion. Only by building on that effort can we realize the true potential of the American economy.

Thank you, Mr. Chairman.

Senator Jepsen. Thank you, Chairman Volcker.

In keeping with your reputation, that was truly an analytical, shooting straight from the shoulder presentation, and I compliment you for it.

I would refer to one statement, where you state:

> I would emphasize the word "sustainable" in that communique. A short-lived recovery, without staying power and accompanied by reignition of inflationary pressures, offers no real solution to our problems or those of developing countries.

And time and time again throughout your presentation you have mentioned that we need to be sure that we keep the ground we've gained in this hard-fought battle against inflation. You ended your presentation saying that you firmly believe we've laid much of the foundation for a long period of noninflation.

Now, as we both experienced yesterday, we are beginning to hear that maybe a little inflation is good timing for everybody. We're hearing that from some surprising sources. Some entrepreneurs in our country are saying that this silent embezzler that we call inflation is our single biggest problem. And yet yesterday you and I both sat in a meeting at noon and heard one of the financial giants of this country suggest that maybe a little inflation might be good for us.

What's your comment on that?

Mr. **Volcker.** I suppose that kind of comment reflects an understandable sense of frustration with the current state of affairs, but my comment on that would be that it's pure illusion to think that we can solve our problems by renewed inflation.

There was a period in this country and elsewhere in the 1950's and to some extent in the 1960's, where the thought was a little inflation would be a useful tonic. It would surprise people. It would result in a kind of feeling of at least modified euphoria, as profits benefited from inflation and prices of houses went up, and the like. And it's conceivable there was something to that theory while inflation was relatively modest and people didn't expect it. But the rules of the game change entirely as soon as people begin expecting inflation as they began to do during the 1970's. The game is up. In fact, I think by the end of the 1970's people had become frightened enough so they began anticipating even more inflation than what was a reasonable prospect. When they anticipate inflation, they hedge against it—they hedge against it in part by demanding higher interest rates—and then the game is over; you can't expect inflation to have a stimulative effect when it's fully anticipated. I think in the present state of affairs, having gone through that experience in the 1970's, it is indeed an illusion to think we can build the strength of the country on inflation.

Senator **Jepsen.** Well, assuming that recovery is indeed underway with all the economic signposts except unemployment in place, our job now is to sustain recovery. Assuming that, what is the Federal Reserve's role in sustaining this recovery? How can the Federal Reserve contribute to the achievement of a sustained recovery?

Mr. **Volcker.** What we want to do in general is easy enough to describe; it's a little more difficult to implement. We certainly want to provide enough money, enough liquidity, commensurate with a continuing recovery. We have to be very careful, at the same time, that we don't overdo it, for fear of regenerating those inflationary expectations and inflation itself. I say regenerating; I'm under no illusion that those forces have disappeared. They are more quiescent than they were. My own feeling is that the expectations lag behind the reality, that the inflationary outlook, in my personal judgment, is better than most people believe because attitudes change slowly in this respect. But there are all sorts of indications of the continued sensitivity of the public to future inflation.

I believe it was you—it may have been another member of the committee—who asked about whether the future deficits were creating fears about future inflation or whether the rapid growth in the monetary base and money supply in recent months was contributing to concern. It's very hard to separate those factors. I don't think there is any question that people who look at the kinds of deficits that are in store if we take no action worry about the inflationary consequences. I would think that is an important factor.

I do not believe the increases in the money supply we have had recently carry any inflationary potential. Obviously, in making that judgment in the conduct of policy, we would not have undertaken to accommodate those increases if we thought they had inflationary potential. I think there is sensitivity of opinion in the marketplace to those money-supply numbers running higher than usual in recent months.

Senator JEPSEN. Along that line, just what is it that you're doing that we ought to be watching? In just trying to understand monetary policy, what should we be keeping our eye on? Should we be watching the interest rates, the money supply? If we're watching the money supply, what's most important, credit, reserves, M_1 or M_2? What is the thing we should be watching?

Mr. VOLCKER. I try to watch everything, and I don't know what other advice I can give you; that's the essence of the problem. Certainly you should look at those money supply figures, but I think developments during 1982 illustrated that during this particular period of time we can't point to an unvarying, constant relationship between those money-supply numbers and the things we're really interested in; namely, the economy and inflation.

Senator JEPSEN. Excuse me, Mr. Volcker. What is the current main emphasis? Pretend for a minute, if we could follow only one indicator, what would it be?

Mr. VOLCKER. If you could only follow one indicator you would be making a mistake. That's the only answer I can give you. There just is no one indicator that you can look at; that's the essence of the matter. Ultimately, obviously, we're interested in the economy, in sustainable growth in the economy, and in the progress on inflation that's all tied up with that. But I honestly think you are making a mistake if you look at one indicator as the key to monetary policy, the key to inflation, the key to the future.

Senator JEPSEN. Let me come back around this a little different way. Where is the current main emphasis?

Mr. VOLCKER. The emphasis is clearly on wanting to support recovery while maintaining the progress on inflation. That's the emphasis in terms of objectives.

Senator JEPSEN. That's the big national goal. Now what is your main emphasis of the Federal Reserve Board?

Mr. VOLCKER. Let's look at the operating techniques. The decisions we have to make from day to day are about the provision of reserves according to a path which we set out for bank reserves related to money-supply objectives. But we have been willing to tolerate, accommodate, a range of objectives for the money supply during this period. We've been willing to accommodate a more rapid increase in the money supply, based upon a judgment of everything going on in the economy that we think is relevant—and that includes inflation, current business conditions, the forecast of business conditions. We have to take account of the foreign-exchange value of the dollar. We take account of the pressures on the financial system. I'm giving a complicated answer but it's a complicated subject. I would be delighted to say, "Look at "x" and that's it." I can't say we look at "x" and that's all; we have to look at a variety of factors.

Senator **JEPSEN.** I thank you.

Senator Kennedy.

Senator **KENNEDY.** Thank you, Mr. Chairman.

I would hope in looking at those various indicators you're looking at the number of unemployed. I didn't hear that particular item mentioned in your list, and the pain, and the suffering, and the anguish that is taking place in our country; and I would hope that when you're looking at the size of the deficits that you're also going to look at the fact that the wealthiest individuals in this country are going to get an additional tax cut next year and have their taxes indexed over the period of future years which is going to, even according to the President's own state of the Union, add $790 billion to the deficit over the period of the next 5 years. And I would certainly hope, when you're studying those various factors, such as what the average family is going to pay for interest to buy a home, whether young people are going to be able to borrow the money to go to college, whether there's going to be survivability for our senior citizens as they're going to have to go on out now and scrape together that money which will not be available to them because of the freeze on the COLA's, and because of increasing deductibles and copays for their medicare—what kind of advice are you giving to this President for a more fair and just society?

Mr. **VOLCKER.** I try to keep in mind what our role is, Senator Kennedy. We are responsible for monetary policy and not for many of the matters that you brought up in your statement. Those are your problems, and the administration's problems.

Senator **KENNEDY.** Well, I believe that you are obviously not detached from what is happening in this society and what the impacts of these monetary policies are going to be on the human condition.

What was your reaction the other night, Mr. Volcker, when the President said in his state of the Union, "The single thing that can start the wheels of industry turning again is a further reduction in interest rates. Right now with inflation as low as it is, 3.9 percent, there is room for interest rates to come down."

Are you going to bring them down?

Mr. **VOLCKER.** You may attribute more power to us than we have. I think the President went on to mention in that speech the factors that we're maintaining the levels of interest rates, and he spoke about the fears of inflation. I think that is a very valid comment. We obviously, in the short run have influence on interest rates and particularly short-term interest rates, but we try to judge that influence with some awareness of its implications over a period of time.

Senator **KENNEDY.** Well, let me just get back to the question. Are you going to bring them down? The President has said, "Right now with inflation as low as 3.9 percent there's room for interest rates to come down." Now do you agree with the President or don't you?

Mr. **VOLCKER.** I believe there is room for interest rates to come down in the kind of economy that I foresee with inflation kept under control.

Senator **Kennedy**. How about the kind of economy the President foresees? He's sending a message, isn't he?

Mr. **Volcker**. In the kind of economy that the President foresees, with the kind of growth and inflationary outlook that the administration is projecting, I believe that over time interest rates can come down.

Senator **Kennedy**. Well, does the President have to talk with you through speeches or do you and he sort of have a little chat once in a while? You remember I asked before in another one of these meetings when the last time it was when you chatted with him. Could you tell us when the last time it was that you talked to him about interest rates?

Mr. **Volcker**. In terms of direct conversation, I think the answer I will give you now is the same answer I gave you last time.

Senator **Kennedy**. Well, what was that answer?

Mr. **Volcker**. It was some time ago.

Senator **Kennedy**. More than 6 months or more than 8 months?

Mr. **Volcker**. I think more, yes.

Senator **Kennedy**. More than a year ago?

Mr. **Volcker**. No.

Senator **Kennedy**. More than 8 months and less than a year, on an issue which is of vital importance to the average family, small business, the farmers in this country, the issue which is basically fundamental to the recovery of this Nation.

I'd like to—and I know the time obviously is close. This chart over here indicates what percent the real prime rates have been in the years following a recession, periods of renewed growth. During those years there were Republican and Democratic Presidents alike and we see what the policy of the Fed is in 1982. It's 7.6 percent in real prime rates. This is what we're talking about for the average family.

Now you commented earlier in your speech that the conditions are different now. We've got a whole new set of cards than we had in the 1960's and the 1970's. Well, I could read a list of both Nobel Laureates, economists as well as others who have studied it who would take strong exception, and believe that we ought to return to the historic and traditional relationship between interest rates and the rate of inflation.

Now what is it that you know so much better than these others, both Nobel Laureates, skilled economists, business men and women in this country, that say that the meaningful way that we can get this economy back is to try and follow the historic and traditional relationship between interest rates and the rate of inflation, at least give that policy an effort and a try?

Mr. **Volcker**. I think we can find Nobel Laureates on both sides of that issue, Senator Kennedy, but——

Senator **Kennedy**. The one thing we know is that it's not working now. Your policy certainly isn't.

Mr. **Volcker**. There may be some disagreement about that.

Senator **Kennedy**. Not among the 12 million men and women who are out of work and those that aren't being able to make it today.

Mr. **Volcker**. I would reject the implication that we have buttons to push on monetary policy to cure these problems. Obviously, if we did, we would press them. Among the buttons we don't have to push are the judgments that are made by the millions of people participating in financial markets about what rate of interest they're willing to settle for at any particular time against their own experience. That red line you have on that chart, I don't know precisely how it's calculated. It may be appropriately in red for several reasons, because that's part of the alarm bell that is rung after a decade of accelerating inflation. During that previous period people who lent capital weren't very happy about their rates of interest in retrospect that they were getting during that inflationary period.

Senator **Kennedy**. But the point I would make, Mr. Volcker, in each of the 1961, 1969, and 1973–74 recessions, under President Ford, each of those areas with the rejection of the interest rates and relating them to the real rates of inflation, we saw expansion and real growth in our economy and for the most part a lowering of unemployment. That has been the historic pattern that we have seen and now we have gone into an interest rate policy which runs completely contrary to this pattern, and you claim that there are new factors that are affecting it and we are feeling the enormous, devastating impact across this land.

Mr. **Volcker**. We have no interest rate policy, and no policy of maintaining interest rates at high levels. We would be delighted to see them at lower levels. The questions is what the facts—indeed, the changing facts—of the economy permit. Interest rates were negative during a good part of the 1970's, as inflation accelerated in real terms. Lenders were not very happy about that, and they fear that those same inflationary forces may recur.

We're not going to deal with that problem by sending out a message of inflation. If you want some real hope, as I do, that those interest rates in real terms will come to much lower levels, we had better not send out messages to the markets that we're going to inflate.

Senator **Kennedy**. My time is up. Thank you, Mr. Chairman.

Senator **Jepsen**. Congressman Wylie.

Representative **Wylie**. Thank you very much, Mr. Chairman.

Chairman Volcker, Senator Jepsen has said recovery is underway and I believe it is. Senator Kennedy has just mentioned unemployment as a factor that indicates that maybe the recovery is not underway.

In your testimony before the Banking Committee last year, I think in February, you suggested that economic recovery was in the offing. It may have been delayed a little bit given the fact that the unemployment rate is as high as it is. Maybe some of those expectations haven't been realized. Is that a fair statement?

Mr. **Volcker**. If I were speaking as long ago as last February, I wasn't looking for an absolutely imminent recovery, but I think it's fair to say we are expecting recovery before now and it has been longer in coming than we anticipated.

Economists are not very good at projecting turning points. That's been true in both directions. I remember, when I first came to testify as Chairman in 1979, the fashionable economic forecast was for recession right away, and that forecast continued for about 6 or 9 months. Eventually we did have a sharp and brief recession, but it came 9 months after people had projected it. This time the projection unfortunately has been delayed on the upside. I do think now, given the disappointment in the past, that I want to be cautious, but I think we can see some crocuses blooming.

Representative WYLIE. Is it fair to ask what factors in retrospect might have contributed to the delay in the outcome of the expectations?

Mr. VOLCKER. I think one factor that may have been underestimated by a good many people are international interactions. Our export picture has been unprecedentedly poor, not so much in absolute levels but in direction, during a period of recession; and that reflects, as I indicated in my statement, both exceptionally high levels of the dollar, which certainly weren't anticipated, and the fact that demand for our exports has been poor because of developments elsewhere in the world. This has been part of the worldwide process, and I think perhaps that was inadequately analyzed or predicted, let's say, a year ago.

Representative WYLIE. Developments in other parts of the world? What do you allude to there?

Mr. VOLCKER. Developments in other parts of the industrialized world, to generalize, have been very similar to developments here. We've all been caught up in an inflationary period. Policies among these countries have been directed pretty uniformly toward restraining inflation, basically for the same reason that our policies have been directed in that way. That's exacted a cost, a short-term cost, throughout the world, in terms of restrained output, recession, or very little growth, depending upon which particular country you look at.

Representative WYLIE. High interest rates are contributing to that?

Mr. VOLCKER. High interest rates are, of course, a direct contributor to that, yes.

Repesentative WYLIE. The bottom line to economic recovery is probably lower interest rates—isn't it?

Mr. VOLCKER. If you could just will lower interest rates, lower interest rates would certainly help the economy expand. There's no question about that.

Representative WYLIE. What are the reasons why short-term interest rates have seemingly fallen so precipitously and yet long-term interest rates remain high?

Mr. VOLCKER. I'd make two comments on that. Long-term rates have, of course, fallen, but not as far as short-term rates. I think it's fair to say the long-term rates are probably a better reading of the psychological state of affairs, what expectations are over a period of time, because when you make a long-term investment you're making a bet out into a number of years in the future. Long-term rates, in my judgment, are as sticky as they are in considerable part because of lingering concerns about inflation.

Representative WYLIE. The President's state of the Union message was mentioned here a little earlier. Overall I thought it was an excellent statement and I thought it was on a positive, upbeat tone; but at the same time, it was realistic. And I was watching some of the columnists on one of the news programs this morning and they talked in terms of the President's state of the Union message and expectations.

Have you been asked, Chairman Volcker, what you thought of the President's state of the Union message vis-a-vis the state of the economy?

Mr. **Volcker.** I try assiduously not to make comments that could be interpreted as having a political flavor to them, and I don't want any comment to be interpreted in that light.

Let me say, from my particular point of view, I think the state of the Union message reflected an appropriately sober view of the problems involved in the deficits and the deficit potential over a period of years and that it proposed a series of measures, that can obviously in their specifics be debated, to attack that problem. Whatever the particular measures are, that attack on the deficit is central to a successful economic policy in the months and years ahead, so I was very encouraged to see that emphasis in the message.

Representative **Wylie.** I was encouraged by that, but I am very discouraged by reports of a budget deficit of the size that is anticipated. There are reports that it may be as high as $200 billion for fiscal year 1984.

Could a deficit of the size of $200 billion swamp the Fed? Put another way, would it be very difficult for you under those circumstances to have any impact as far as interest rates are concerned?

Mr. **Volcker.** The bigger the deficit, the more pressure there will be on interest rates. But let me make a big distinction between, let's say, the deficit of about $190 billion that's projected in 1984, when the administration is still understandably projecting a high level of unemployment, and the deficits of $200 billion plus that are projected for 1985, 1986, 1987, and so forth, when much lower levels of unemployment are being projected. I'm speaking of projected deficits before any action.

When you have that kind of deficit on top of an expanding economy with declining rates of unemployment and with unemployment getting back to more normal levels—if there is such a thing—you've got a much bigger problem than you have with the same size deficit during a period of low capacity utilization. The difference is, in major part, that you get less private borrowing during a recession or slack period than you get during a more prosperous period. If you don't get the deficit out of the way as the private economy expands, you'll have a collision. Yes, in 1984 it's a concern, but that concern becomes progressively greater as you go beyond 1984.

Representative **Wylie.** I was afraid of that. My time has expired.

Senator **Jepsen.** Senator Proxmire.

Senator **Proxmire.** Mr. Volcker, in response to Senator Kennedy, you indicated there are limits on what you can do to bring interest rates down. What would happen if the Federal Reserve Board decided to reduce the discount rate and take such open market operations action as would support that and make substantially more credit available? Wouldn't that tend to bring interest rates down?

Mr. **Volcker.** We didn't do it for experimental reasons, but we had an interesting observation—let me put it that way—in December. You may recall we reduced the discount rate by a half a percent effective December 14. The market observed that the signals that are normally in place for a reduction in the discount rate, in their judgment at least, were not all in place at that time. We had had, specifically, some fairly rapid increases in money over the previous month or more. The discount rate was reduced, and a couple of weeks later market interest rates were higher rather than lower. I think they went down for about

4 or 5 hours and then began rising again, and I think this was accompanied by some expression of concern as to whether the Federal Reserve would become too liberal over a period of time, whether that discount rate reduction, apart from its direct impact in reducing rates, might raise some questions about what our posture would be over a period of time. There may have been other reasons for this market reaction. All I know is that the discount rate was reduced and interest rates didn't go down. In fact, the discount rate has been reduced three times since October. Somebody noted earlier that interest rates—most sensitive market rates, not the prime rate—are a shade higher now than they were in early October as I recall, and the discount rate has been reduced three times since then.

Senator PROXMIRE. Well, the chairman pointed that out, but I notice the corporate bond rate is lower, the commercial paper is lower, the discount rate is lower, the prime rate charged by banks is lower, and new home mortgages are lower. Now some of the shorter term, 3-month Treasury bills and U.S. Treasury security yields are about the same, not much different.

Mr. VOLCKER. That's right. It's not a big change. Interest rates have been fluctuating over a range during this period.

Senator PROXMIRE. The reason I raise this point, Chairman Volcker, I realize that any one of your tools have to be used in conjunction with others. It just seems to me that if you do lower the discount rate and at the same time persist month after month for a period of time making more credit available that it would seem to me that logic would follow that with more supply of credit available that the price of credit or interest would tend to go down provided you have the kind of situation you have today where you have low inflation and where you have a terrific vacant capacity in industry and so forth.

Mr. VOLCKER. I think that would be a normal expectation, all other things equal, as we are fond of saying. But then you get into these awkward questions of when the countervailing factors, so to speak, outweigh that fact of "pushing rates down." You get into another question which is I think central to the issue. You may be able to "push them down," to use your words, in the short run—at least short-term rates, although it's problematical what you can do to long-term rates—but, that's not very productive if you have some result in the short run for a matter of weeks or maybe even months but you have set in motion forces that are going to reverse the whole thing a few months down the road. That's the last thing we want to do, to take actions now that will set in motion forces that abort a recovery or restimulate inflation some months down the road. I don't think that's in anyone's interest. In other words, in my judgment, we have to worry at least as much about the sustainability of the recovery as the rate of speed with which it takes off in the next few months. It's the sustainability that's the key, in my judgment.

Senator PROXMIRE. Now you devoted much of your statement, almost half of it, to the international financial situation, and there's great concern here. You know we have to act on the IMF replenishment. We may have to act on other demands. If the Congress should go ahead with the IMF replenishment to provide more dollars for IMF and if as has been testified before the Foreign Relations Committee the IMF insists on bailing-in the banks—not bailing them out but bailing them in, as they say—and by that I mean they would require the banks to provide additional credit, probably four or five times as much credit as the IMF provides—now this means a considerable drain on the credit that's available.

Would the Federal Reserve Board be able to accommodate that? Would it accommodate that additional demand for credit, that is, the sum of the IMF demand on our markets plus the American banks which it would also increase their credit?

Mr. **Volcker.** I don't think those additional demands are terribly large relative to the whole size of the American capital market. I'd also point out that these programs also imply—more than imply, indicate in the actual numbers that are cited—a rather sharply or a significantly reduced flow of bank credit abroad. We're not talking about a situation where this flow is increasing on a net basis but rather one where it's tending to decline.

Senator **Proxmire.** Isn't that on the assumption that this will be temporary, there will be considerable recovery and that seems to be less likely if we have a 1.4 percent growth in our economy and if our economy is so critical to the rest of the world—the rest of the world seems to be lagging behind us, especially the lesser developed countries—isn't there likely to be an even greater demand?

Mr. **Volcker.** I was thinking specifically of the programs that are worked out in rather specific terms for 1983 when I made that statement. When one looks beyond 1983, obviously the situation is fuzzier. But if these programs are successful of adjustment by the borrowing countries, as we certainly hope they will be, I would hope and expect you could look beyond 1983 to increases at a progressively slower rate of speed.

Senator **Proxmire.** Well, if they are not successful—and I'm not—

Mr. **Volcker.** If they're not successful, obviously we've got problems, but now let me return to the implications of that for domestic credit markets.

To the extent there is uncertainty, to the extent there is concern, to the extent there are strains on banks in the United States, and elsewhere growing out of this situation, you would expect they will be more cautious in lending domestically and they will tend to charge higher rates domestically than they otherwise would. That's a natural, almost inevitable, reaction to problems that they might have in that area as in other areas.

You just focused on what is best for U.S. growth, for sustaining U.S. growth and for getting the prime rate down and other private rates down; clearly, we are much better off by stabilizing, by managing this international situation than the reverse.

If the banks and the public feel that they have an international financial crisis on their hands, that is the opposite of an environment favorable for domestic expansion. We are really talking about something here which has the most direct implications for U.S. financial markets and for growth in the U.S. economy.

Senator **Proxmire.** My time is up, Mr. Chairman. I'd like the Chairman of the Federal Reserve, if he would, furnish the committee with details supporting the argument that he's made that the kind of policies he's advocating will not result in a greater demand on the limited credit that we have available.

Mr. VOLCKER. I'd be glad to.

[Chairman Volcker subsequently submitted the following information in response to a request by Senator Proxmire that he "furnish the committee with details supporting the argument that he's made that the kind of policies he's advocating will not result in a greater demand on the limited credit that we have available."]

There are a number of ways to assess the effects on domestic credit markets of the increase in international bank lending that has been suggested in connection with the adjustment programs of the major international borrowers among the non-OPEC developing countries Argentina, Mexico, and Brazil. One approach is in the context of the overall balance of payments; a second is in terms of the specific amounts involved for these countries; and a third is in terms of the repercussions on domestic credit markets of a breakdown of private international credit flows.

In the context of the overall balance of payments, any increase in private bank credit has only limited domestic credit implications in the short run. The outflow's first effect would be to tend to lower the exchange value of the dollar, which would lead in time to larger net U.S. exports. But the effect on the trade balance would take some time to develop, and until it did the borrowed funds would have to be held, either by the original borrowers or by others, in U.S. credit markets.

For instance, dollar credits extended to foreigners and not spent immediately for U.S. exports would usually be converted into local currency to finance domestic business. The purchaser of the dollars could be a private party or a government that wants to avoid appreciation of its currency or add to its reserves. In the latter case, we would quite often see that government buying U.S. Treasury obligations. Cutting through the intermediary stages, the additional lending to foreigners (or a large part of it) tends to return to some sector of the U.S. credit market. In this example, the U.S. banking system may hold larger claims on foreigners, but it has had to finance less Government debt, so that the amount of credit available to private domestic borrowers would not change much. In other cases, the capital inflow precedes the capital outflow.

In the longer run, if there is a large persistent increase in net capital outflows from the United States the dollar will be lower in the market, our net exports will be larger, and the effect on U.S. business would be the same as if the credit had gone directly to U.S. exporters to finance their foreign sales.

Thus, even if the incremental bank lending in connection with these programs were quite large, it would not in itself create any difficulties for domestic borrowers. However, the additional bank lending contemplated under the various arrangements between banks and major debtors is in fact a considerable reduction from the rate of lending over the past few years.

In the negotiations that have taken place between commercial banks and the authorities of Mexico, Brazil and Argentina, the banks have agreed that, if the borrowers are following the adjustment programs agreed with the IMF, the banks would provide net new financing of about $11 billion. In addition, repayments on existing debt have been postponed. That amount of new financing would be less than half of the average annual increase in bank claims on these countries in the 1979–81 period (see table). It would represent a 7½ percent increase over the amount outstanding at the middle of 1982, compared with average rates of increase of nearly 30 percent in the 1979–81 period.

U.S. banks account for about 35 percent of total bank claims on these three countries, and it may be assumed that their share of the $11 billion of new financing would be roughly in that proportion, or about $4 billion. That amount is less than half the amount loaned to these countries on average in 1980–81, and represents a considerable deceleration from the 25 percent rate at which U.S. banks were increasing their claims on these countries in 1980–81.

As an indicator of the relative scale of lending to these countries by U.S. banks, such lending can be compared to total assets. That comparison for the largest banks is made in the attached table, which shows the ratio rising from 1979 to mid-1982, and reaching 5.4 percent at that date. These largest banks account for about 60 percent of all lending to these countries by U.S. banks, and most likely would account for a somewhat larger portion of the $4 billion increase in prospective U.S. bank lending to these countries. At that rate, the increase indicated for 1983 would represent not more than 6 percent of the likely increase in the assets of the banks for the year. In the 1979–82 (June) period the increase in claims on these countries by the nine banks represented about 15 percent of the total increase in their assets.

Finally, the moderate further extensions of foreign credit that are involved in these programs may very well be essential for the maintenance of a healthy flow of bank credit in our domestic credit market. A sudden cut off of lending by U.S. and foreign banks to the countries with severe liquidity problems could force them to suspend all servicing of their debts. That event would trigger write-offs of a large amount of banks' assets, weakening their capital base and most likely causing them to slow down the expansion and raise the cost of domestic credit that would normally be taking place. It would be a serious error to take a risk of that kind of blow to our recovery efforts when there is a good chance that the liquidity problems of these countries can be overcome with careful management.

A more general point may be added. There are very significant feedbacks from the economies of other countries to the pace of economic activity in the United States. Should a sudden contraction of foreign lending occur, the economies of some of our important trading partners would be forced to contract abruptly. This could mean another year of declining U.S. exports, after a year in which the weakness of the external sector was a major factor in the slowdown of the U.S. economy. In that perspective, a relatively small financing flow may well have a widespread positive effect on the U.S. economy.

Attachment.

Bank Claims on Argentina, Brazil and Mexico
(amounts in billions of dollars; end of period)

	1975	1976	1977	1978	1979	1980	1981	June 1982
Total	31.5	42.5	50.2	63.2	83.0	108.1	134.5	145.0
U.S. banks	18.7	24.7	25.8	26.8	29.9	37.0	46.7	52.4
Non-U.S. banks	12.8	17.8	24.4	36.4	53.1	71.1	87.8	92.6
U.S. banks % of total	54.5	53.3	49.7	39.8	36.1	35.9	36.6	36.7
Increase, total	n.a.	11.0	7.7	13.0	19.8	25.1	26.4	10.5
U.S. banks	n.a.	6.0	1.1	1.0	3.1	7.1	9.7	5.7
Non-U.S. banks	n.a.	5.0	6.6	12.0	16.7	18.0	16.7	4.8
Increase, percent, total	n.a.	34.9	18.1	25.9	31.3	30.2	24.4	7.8
U.S. banks	n.a.	32.1	4.5	3.9	11.6	23.8	26.2	12.2
Non-U.S. banks	n.a.	39.1	37.1	49.2	45.9	33.9	23.5	5.5
Claims of nine largest U.S. banks			15.6	16.4	18.2	22.7	27.4	30.5
Total assets of nine largest U.S. banks			372.5	422.5	486.1	531.0	564.6	566.3
Ratio: Claims on three countries to total assets of the nine banks			4.2	3.9	3.7	4.3	4.9	5.4

Mr. VOLCKER. Without waiting for the record, let me just make one point in connection with the point I just made.

When the Mexican situation first surfaced in the public mind in August–September, it came on the heels of the uncertainties growing out of the Penn Square Bank situation in Oklahoma. In that atmosphere of concern in the international and the domestic financial system, you had a period of time in which bank lending rates and bank deposit rates moved toward historically high levels relative to other interest rates, relative, let's say, to the Treasury bill rate; the spreads widened very appreciably.

Since then they've narrowed again, but the spread between the prime rate and other market rates is still relatively wide.

Senator **Proxmire**. Thank you, Mr. Chairman.

Senator **Jepsen**. Congresswoman Snowe.

Representative **Snowe**. Thank you, Mr. Chairman.

Chairman Volcker, last week you suggested that the Federal Reserve would not pay for future large deficits by excessive money growth. You said the result of this excessive money growth would, in your words, "create further doubt about the prospects for further disinflation and lower interest rates aggravating the uncertainties in those respects related to the budget deficit," and so on.

And the result was a downturn in the stock and bond markets and the Treasury issue set for early next week will go off at a higher interest rate.

I think this is a good example to show that the markets are extremely sensitive not only to the questions of faster and slower money growth but how that money growth interacts with fiscal policy, and it's this potential disarray caused by a collision between large future deficits and a nonaccommodative monetary policy that has the credit, stock and bond markets very nervous.

My question is this. Have you discussed with the administration—and obviously it hasn't been the President, based on your response to Senator Kennedy's question—discussed various money creation scenarios with regard to potential actions that will be taken by Congress to cut the deficit? And, second to that question, in your opinion, to what extent will future deficits have to be reduced? By half or more than half or should it be a percentage of the gross national product in order to accommodate the monetary supply and the targets that will be established by the Federal Reserve Board and also for us to prevent higher interest rates in the future because of those deficits?

Mr. **Volcker**. Let me make one preliminary comment on your first observation. I think it's implicit in your statement, but let me just say it explicitly. In a sense, extraordinarily large deficits leave us in a no-win position. If you don't accommodate them, you've got a kind of clash in the marketplace; if you do accommodate them, you get more inflation and also an eventual clash in the marketplace. Stating it that way, I think it's clear there's no escape from the problem created by those deficits through monetary policy.

Of course, I discuss fairly continuously these sets of problems with administration officials. We do not, in the Federal Reserve or in those discussions, compare different hypothetical courses for the money supply over a series of years with different deficits, because I think we start from the same general proposition that the course of the money supply over that period of time should be determined by what's necessary for the overall needs of the economy and for inflation, and that really doesn't change with the deficit for the reason I suggested earlier; there's no escape from the problems created by the deficit through manipulating monetary policy.

One can discuss—and it's an interesting matter of judgment—how much is too much in the case of deficits, and there's no precise arithmetical answer to that question. It makes our job easier, it makes interest rates lower, I think it makes the economy healthier over a period of time, the nearer we can get to balance. When one looks out at these projections in 1986 and 1987, that is a very large challenge to get the balance in that time period. I think a certain skepticism is justified as to whether that is possible, but I don't think, in one sense, it's necessary. It would be nice, but if we can show significant and continuing progress toward that objective during this period of expanding economic activity, I think things will obviously be much better than they would be as things stand now, and the situation will be quite manageable.

I think the President's program suggest, just in terms of numbers, reducing the budgetary deficit by $125 billion approximately in 1986; $150 billion in 1987. As orders of magnitude at which to aim during that period of time, they seem quite appropriate to me.

Representative SNOWE. Mr. Volcker, what weight do you place on the President's budget, given the fact that obviously Congress will make some adjustments in reducing that budget deficit even further beyond the President's recommendations? Do you expect the Federal Reserve Board is going to be somewhat flexible in the next 6 months or so while Congress enacts a budget resolution?

Mr. VOLCKER. I think we have all learned from experience that budgets are not enacted before they're enacted and we've had some experience in recent years that they don't get enacted; they get resolved, I guess is the right description.

Representative SNOWE. That's true.

Mr. VOLCKER. The President has, in effect, asked you to look out over a longer period of time than simply 1984. I think that is quite important; everyone will be looking to see to what extent you are dealing with those big structural deficits out there in the years ahead.

We are left in a situation of uncertainty about these matters now and in the months ahead, as you struggle with these questions. That's inevitable. We will use what degree of flexibility we think is justified during this period precisely as we have during the last 6 months.

Representative SNOWE. So will the Federal Reserve Board's monetary policy be established on the administration's budget rather than any future action that might be taken by Congress?

Mr. VOLCKER. I would put it the other way around. We will establish a monetary policy and continue to implement a monetary policy that we think is appropriate for the circumstances. Your actions on the budget as a first approximation will have a lot to do with how interest rates develop, how expectations develop in the marketplace in a relatively constructive or less constructive way within that framework of monetary policy. But the monetary policy framework, by the nature of things, has to be set continually, day by day, and it's not really altered by your budgetary deliberations; rather, your budgetary deliberations are going to have a lot to do with how the market reacts to the monetary policy and to other factors.

Representative SNOWE. On another matter, Chairman Volcker, during the last two winters, the money supply has grown rapidly. From September 1981 to January 1982 M_1 grew at about a 12-percent annual rate. From December 1980 through March of 1981 the M_1 grew at an annual rate of 13 percent. Both of these expansions in M_1 were followed by long contractions in the money supply. In 1982 the money supply dropped from April to August and in 1981 the money supply did not rise above the April level until November.

Once again we have seen during the latter half of the year the money supply grew very rapidly, roughly at a 15-percent rate since July. Many believe that the last two contractions caused the recession beginning in 1981 and continued that recession into 1982. I'm certainly quite worried, therefore, that this latest expansion will be followed by another contraction in the money supply.

Do you believe that because of this dramatic rise in the money supply there will have to be some months of holding steady on M_1's growth and also, to that question, how can we prevent the stop and go cycles concerning the expansion and contraction of the money supply?

Mr. VOLCKER. Let me approach that question by saying the 1980 and 1982 experiences seem to me to be quite different. In both, we had a relatively rapid expansion of M_1 for a period of some months. In 1980, that paralleled a quite vigorous growth, an unexpectedly vigorous growth, in the economy during that period; I think the money supply was being pulled up, if you will by an expanding economy. In 1982 the economy had certainly not been expanding, and what we see in 1982 is an unprecedented drop in velocity for the postwar period. The money supply has been expanding; the economy in the fourth quarter has been declining and in the third quarter increasing by a relatively small amount. There is more liquidity in the economy but the money supply has not been pulled up by expanding economic activity.

I think it is our conclusion, and the conclusion of many other people, difficult to measure in its specifics, that the money supply has been influenced during this period by two factors. One is kind of technical and institutional, but involving very massive flows of funds, arising from such things as the maturity of the All Savers certificates—which were in part placed in transactions balances, certainly for a while—and continuing more importantly into the changes dictated in part by the Congress with the introduction of this money market deposit account. For the first time, people can go to their banks, because of very vigorous competition for that money, and get a very high level of interest rate on very liquid money. We haven't had this to this extent before; it was not unexpected that this would pull money, in the case of MMDA's into M_2 from sources that we didn't classify as part of the money supply. So you get an artificial bulge in the money supply from those institutional changes.

I don't know precisely how many of these new deposit accounts exist at the moment because they are rising so rapidly that the number just leaps from week to week, but there may be about $180 or $190 billion in those accounts in the course of not much more than a month, 6 weeks or so. There's been an enormous shift of money, some of which has been pulled into the money supply figures from sources of funds that we don't include in the money supply. You get a distortion; it's hard to measure in detail.

The other factor is that in a period of considerable uncertainty, with unemployment rising, interest rates falling, interest rates having been quite unstable for a period of time, people say, "I want to play it safe. I want to hedge for a while. Short-term interest rates are still relatively high. I just want to sit on my money for while and I want to increase my liquidity."

Our appreciation of that desire for liquidity is a factor in the growth of the money supply and has led us to accommodate some of that growth; if we didn't we would have a depressing influence on the economy and we did not think that appropriate at this point in time. We think accommodation of that demand for liquidity is consistent with the basic purposes of policy, that is, maintaining appropriate restraint over a period of time, avoiding inflationary pressures. But statistically, that demand is reflected in a sizable increase in the money supply.

I don't think that's inappropriate, but it's confusing when people have been accustomed—going back to the chairman's question—to looking at one measure of monetary policy. If M_1 is the measure of monetary policy, and it's the be-all and end-all, this growth looks expansionary and inflationary. I do not believe that M_1 is the end-all and be-all of monetary policy. You've got to evaluate these short-term movements with an element of judgment. The normal expectation would be—and we want to be cautious about it—that this velocity will revert to a more "normal" pattern, that this will be at least in part a temporary abberation.

But there are also some reasons to believe that the trend of velocity may change, although not as radically as implied by the movements of the last 6 months.

There may be an answer to that in the history books, but we have to decide and make some judgment about it as we move along from day to day, and we allow for the possibility that the times may be changing. We also allow for the possibility that it is an abnormal demand for liquidity during this period.

Senator JEPSEN. The Chair will now recognize the very distinguished vice chairman of this committee, Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Chairman Volcker, with all of the talk we have had about interest rates this morning, I don't recall your saying that a principal objective for the Federal Reserve will be to get interest rates down. Is that a principal objective?

Mr. VOLCKER. I would answer that question yes and no, I think, Congressman Hamilton.

Representative HAMILTON. I thought you probably would answer it that way.

Mr. VOLCKER. We don't target interest rates and we don't say, "Look, we would like this interest rate and we're going to devote our efforts insofar as possible in the near term to meet this particular interest rate target." That's the "no"part of the answer.

The "yes" part of the answer is that I obviously agree that it would be healthy for the economy to have lower interest rates. That's important to expansion. It would be a healthy reflection of a conviction in the marketplace that inflation is receding. Lower interest rates would be both the rewards of good policy and an important factor in economic activity itself.

We're really concerned with the question of how to get there.

Representative HAMILTON. Let me give you my reaction: That "no" part of your answer is a very technical answer.

Mr. VOLCKER. That is correct.

Representative HAMILTON. The "yes" part has all the human implications.

Mr. VOLCKER. I agree with that.

Representative HAMILTON. Now it would seem to me a person in your position going into your next meeting would have as a principal objective getting interest rates down. Now isn't that going to be a principal objective of yours in the next meetings of the Federal Reserve?

Mr. VOLCKER. Let me express it this way; I think a continuing, principal objective of ours is to get economic conditions that will be consistent with lower and sustainably lower interest rates.

Representative HAMILTON. OK.

Mr. VOLCKER. I would emphasize both lower and sustained; it's the sustained part that in effect presents the difficulty.

Representative HAMILTON. I understand that, but given the situation you now confront, with the President saying we've got to get interest rates down, the Secretary of the Treasury saying we've got to get interest rates down—he told us that yesterday—all or most all of the economists I've seen are saying the same thing, and certainly all of our constituents demanding that we get interest rates down, it would seem to me, if I were Chairman of the Federal Reserve Board, one of the first things I would have as a principal objective would be to get interest rates down.

Now, of course, you've got to take into account inflation. You've got other risks to worry about. But that seems to me to be the overriding concern right now, to get interest rates down. You're not going to have a sustainable recovery unless you get interest rates down. Now how far off base am I?

Mr. VOLCKER. I'm not sure you're far off base, but I wouldn't state it quite that way. The overwhelming purpose of policy is to get a sustained and stable recovery. Interest rates are secondary to that but they are an important component.

Representative HAMILTON. Do you believe you can have a sustained recovery without getting interest rates down?

Mr. VOLCKER. It depends upon the time period you're talking about.

Representative HAMILTON. I'm talking about right now.

Mr. VOLCKER. I think we may be having the beginnings of recovery right now, with interest rates where they are. The kind of recovery that I would see as both desirable and necessary over a period of time—a noninflationary recovery—I would agree can only be sustained by reductions in interest rates over time, because a noninflationary recovery implies to me lower interest rates over a period of time.

Representative HAMILTON. Let me ask you about the standby tax proposal the President made in his state of the Union address. Do you support that proposal?

Mr. VOLCKER. My central concern is obviously with a combination of measures that will deal with that structural deficit. That proposal seems to me one way of approaching it. There are other ways of approaching it, I think that is a reasonable way of approaching this problem and I would and do support it. It's not the only way of approaching that problem.

Representative HAMILTON. Would a better way be to knock out the indexing? There's a question of credibility here, isn't there, in the financial community?

Mr. VOLCKER. Yes.

Representative HAMILTON. Whether or not the Congress is going to do that, whether or not the conditions are going to be met, you're going to have the uncertainty that you just complained about a few minutes ago with the standby tax.

Mr. VOLCKER. Exactly. There is precisely that question. On the question of indexing, you're talking to someone who has congenitally not liked indexing; that is another approach, yes.

Representative HAMILTON. But on balance you support the standby tax proposal?

Mr. VOLCKER. In the context that I expressed it. I don't have any investment in any particular technique for dealing with this problem. That does seem to me a possible and practical technique, but I'm not making those decisions. I would urge upon you the importance of dealing with that problem. That's potentially an effective way of doing it; but if you've got another way of doing it, from where I sit, the other way, depending upon what it is, might be worse or better.

Representative HAMILTON. I understand. Now let me ask about the situation confronting several of the major U.S. banks. I've seen some suggestions that many of them may be or several of them may be overexposed. Do you see any danger to the continued financial soundness of major U.S. banks due to bad loans to developing countries?

Mr. VOLCKER. I think this is a situation that can and must be managed. If we manage it appropriately we can rest content on that score. I think this is not just an American problem; this is a worldwide problem. We, of course, have an elaborate apparatus in this country, in place for many years, to protect the stability of the banks and the banking system.

Representative HAMILTON. Do you think that's adequate under the present circumstances?

Mr. VOLCKER. Yes; I think it is generally adequate. This particular international dimension is, of course, relatively new, and I would not want to fall back on the general support mechanisms. They are there and they are effective, but it would leave disturbances in the international system. I think we have to actively manage the situation before it gets to that point, and that's what we're attempting to do. Just to repeat the point, the IMF expansion is part of that program, and that's why I attach very considerable importance to it. But I certainly think this problem can be met and there need not be concern. I made that statement against the feeling that there has to be a lot of effort devoted to it.

Representative HAMILTON. Do you think that the increase in the IMF quotas is sufficient? I think the Secretary testified yesterday that they're supporting a 40-percent increase. I'm not positive about that.

Mr. VOLCKER. There is still a range of uncertainty in the international discussions, but I feel quite sure that the range that's under discussion, together with the special borrowing arrangement that's already agreed upon internationally, will be adequate, yes.

Representative HAMILTON. All right. There have been some suggestions in the papers, academic journals, and the like—and, I think, the OECD—that some of the economic weakness in the industrial countries is in part due to uncoordinated pursuits by several countries of tight money policy and that the focus of money policy has not been sufficient on the international level. Is that a good criticism and, if it is, what kinds of things can be done to increase coordination of the central banks?

Mr. VOLCKER. First of all, there certainly have been, as a generalization, relatively restrictive monetary policies in the leading countries of the world more or less simultaneously. They have not been coordinated in the sense that a lot of weight has been attached to exchange rate repercussions of those policies.

I'll speak of my own view of the matter. That was, if you will, an expense of the priority that had to be given—speaking of the United States, of our particular domestic problem—to turning around the inflationary situation and getting some sense of stability.

I believe some other countries felt similarly. When one looks ahead to building on the progress that's been made against inflation, and to more stable financial conditions, I, myself, believe that there is room for greater coordination of these policies. It's very difficult to do this internationally, but I am not happy to approach it from the other direction. That would lead to extreme exchange rate fluctuations that could produce damage. They've done some damage to the United States over the past years. That is an element that, in the happier world, I hope we can look forward to taking into account more fully than we have in the past.

Representative HAMILTON. Thank you. My time has expired. Thank you, Mr. Chairman.

Senator JEPSEN. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

I'm tempted to strike out against these efforts to raise taxes. I'll just make a general observation that when you're in a slump or a recession I don't think you're going to work your way out by moving in the direction of increasing taxes. I think indexing is very pertinent and very relevant because it's been the progressive tax rates or inflation that has gotten us, in my judgment, into much of our difficulty today.

But I'd like to go back, Mr. Chairman, to the fact that you seem to be assuming that we do face a period of sustained growth. There are some economists that are not so sanguine about that. They're hopeful that we are, but they think the forces are quite strong in the other direction. But if I understand your testimony, you do agree that growth is probably the most important need today—sustained growth in the economy; is that correct?

Mr. VOLCKER. Yes. But as a footnote, we're not going to achieve that without further progress on the inflation side.

Senator ROTH. I agree with you. Over the long term, I think we've got to take steps that make certain that we're going to grapple with the problem of inflation; but short term, is the situation somewhat different? Right now we've got an oil glut, declining oil prices. We've got farm surpluses, industrial capacity utilization of roughly two-thirds. We've got high unemployment, 12 million.

So can it be said that perhaps there's more flexibility for the Federal Reserve today, short term now, than there has been in the past?

Mr. VOLCKER. Yes. We think that's true. I agree with you on your first point; certainly I think the immediate inflationary outlook is good. And not only the immediate factors look good—the oil, the crops, the surpluses, the excess capacity—but there is also, I hope I'm not overstating it, certain momentum in the basic cost-price structure. So I agree that the immediate inflation outlook should be favorable.

I think that element gives us a little more flexibility in a sense. I think we have been using a little more flexibility in making the judgments about the increases in the money supply and so forth I was talking about with Congresswoman Snowe.

Coming back to the understandable concern about interest rates, we're not dictators of interest rates and we have a hypersensitive audience, understandably in the light of history. When one is concerned about interest rates not only next month but in the second half of the year or next year, one is constrained—and I suppose necessarily constrained—in not taking actions that upset the favorable inflation climate that you describe.

If I may just add a point, I basically agree with your feeling about the inflation outlook. There are, of course, always question marks on the outlook. My optimism is based upon a feeling that there is a certain momentum in the basic cost-price trends, which has to be reflected in nominal wage-and-salary increases. If that changes radically as the economy expands, if we get 6 months of rising employment, rising orders, and everybody goes back to what they interpret as business as usual, meaning the 1970's—that is, if workers say: "I'm going to go for absolutely maximum wage increases" or businessmen say: "I've now got a slightly stronger market and I'm going to move as fast as I can to increase profit margins and increase prices"—then my optimism and your optimism will have to be tempered. I don't expect that to happen. I don't foresee it happening, but I just mention it as a concern in the outlook.

We can affect that climate to some degree—and by we I mean those of us in monetary policy, and the Congress actions on fiscal policy—by the signals that we send about our financial discipline in the future.

Senator ROTH. Well, it seems to me, Mr. Volcker, that I strongly agree that in the long term Congress has to deal with the fiscal problems and try to be sure that spending is brought under control. I have to say that short term I'm not very optimistic that a great deal is going to be done. When you've got 12 million unemployed, the costs of Government are necessarily high.

Mr. VOLCKER. But we're not talking about actions that affect 1983; 1983 is essentially done with, so far as budgetary action is concerned. That's the period when the recession is at its peak. We're really talking about actions that need to be put in place, in my opinion, as early as possible to deal with that period beyond 1983 when we hope and expect the economy will be growing.

My fear is that if that is not done you hamper the prospects for the very recovery that we want. When I look at the hazards to this vision of a continuing sustained recovery, that's one of the risks that I see at the moment.

Failure to handle the international situation would be, I suppose, another kind of potential risk. This thing is not in the bag. I think the prospects are good. It's certainly within our capacity to deal with these problems, but I'm less optimistic if you don't deal with the problems.

Senator ROTH. I'd like to raise just one possibility. If you agree in the very short term the inflation, because of these factors, is not the challenge it was a few years ago, have you given any thought to seeking by whatever means that seem appropriate a much more substantial drop in interest rates as a means of achieving higher growth? As I point out, part of your deficit—as you said in your own opening statement, part of our deficit is caused by the recession.

Mr. VOLCKER. There is no question about that at all at the moment. Of course, the budgetary problem is that 3 years from now the deficit will be equally big, and I hope none of it will be caused by recession. That's the dilemma we're in.

But just talking about how to get these interest rates down, that comes back to the question Senator Proxmire raised. We have a little flexibility; we've been using a little flexibility. But as to deliberate, direct effort to get the interest rates down, what can we do? We can increase the money supply; that's all we can do when you boil it all down. And if we increase the money supply to the extent that we have an adverse reaction—it's not going to be in inflation tomorrow, in my opinion—but in expectations of inflation. If we create conditions such that we push out more money today but will have to pull it back in a few months, that is not conducive to getting interest rates down over any period of time. Our whole effort has to be not just in getting interest rates down tomorrow but getting them down in a way that they stay down. I'm not particularly interested in having interest rates go down for 2 months and then bounce back higher than where they started; I'm sure you're not either. How to get them down and keep them down is the nature of the problem.

Senator ROTH. Well, my time is up. Are we going to have a further opportunity?

Senator JEPSEN. Yes, there will be an opportunity.

Senator Sarbanes.

Senator SARBANES. Chairman Volcker, is it correct to say, as I understand it, that the administration supports the monetary policy that you're pursuing?

Mr. VOLCKER. That's my impression.

Senator SARBANES. So it's your impression that they do support it, that you're following——

Mr. VOLCKER. I don't know that they've made any particular official statement on the subject. Particular members of the administration may have various differences in nuance, but in general my impression is that the administration, as a collective body——

Senator SARBANES. If the administration suddenly were to assault the Fed for the policy it's been pursuing, and you say it wasn't what they thought the Fed should be doing, that would be completely contrary to your understanding and you would be very much surprised; is that correct?

Mr. VOLCKER. I would be somewhat surprised, but sometimes people change their mind.

Senator SARBANES. But up to now you have no reason to think that you're pursuing a policy different from the one the administration wants you to pursue?

Mr. VOLCKER. I wouldn't word it in quite that way, but my impression is that they have no great difficulty and generally support it.

Senator SARBANES. Now, Senator Kennedy mentioned earlier your meeting with the President. My recollection is that when you were asked when you last met with the President, it was last February; is that correct?

Mr. VOLCKER. I would think so, yes.

Senator SARBANES. Would you say that, as Chairman of the Federal Reserve, you've had less direct consultation with this President than other Chairmen and Presidents in the postwar period?

Mr. VOLCKER. I can't go back that far, Senator Sarbanes. Less contact than I had personally with President Carter.

Senator SARBANES. I would assume less than Chairman Miller had with President Carter, certainly less than Chairman Martin had with President Kennedy and Chairman Burns with President Nixon?

Mr. VOLCKER. I think that is true. I don't know about Chairman Martin and President Kennedy.

Senator SARBANES. Well, I expect the Fed has records of the meetings that have taken place between the Chairman of the Fed and the President of the United States to discuss economic matters.

Mr. VOLCKER. I wouldn't think so, no.

Senator SARBANES. Pardon.

Mr. VOLCKER. I would not think that it had a complete record on that.

Senator SARBANES. Could you check that and let the committee know, in rough terms, about how frequently there have been meetings between the Chairman and the President?

Mr. VOLCKER. I don't think a statistical answer to that would be possible. I don't keep any record of my meetings. I didn't keep any record of my meetings with President Carter, and I doubt if there's any additional record of the——

Senator SARBANES. There's no official record prepared of the meetings of the Chairman with the President of the United States?

Mr. VOLCKER. I suppose most of those meetings would be reflected on the appointment calendars of the various Chairmen. I don't know of any official listing in board records of dates upon which Chairmen met with Presidents.

Senator SARBANES. Mr. Volcker, do you expect to be renominated to be Chairman of the Federal Reserve in August when your current term expires?

Mr. VOLCKER. I have no expectations one way or the other on that.

Senator SARBANES. Are you a candidate for renomination? Would you like to be renominated?

Mr. VOLCKER. I wasn't a candidate when I was first nominated.

Senator SARBANES. If you were renominated, would you serve? Would you be willing to continue as Chairman of the Fed?

Mr. VOLCKER. I think that's at this point a question I would discuss only with my wife.

Senator SARBANES. In July of 1981, the 22d of July, I said to you when we were discussing your second monetary policy report for 1981, and I'm now quoting:

> Mr. Chairman, I really want to get you on the record. If this economy goes bad and I think there's as much chance of that as of its going good, somebody is going to be the fall guy for it. Are you concerned that you are being set up to be the fall guy?

And I'd like to put that question to you again this morning.

Mr. Volcker. My concern is with trying to make the best judgments we can make on monetary policy as we go along and under very difficult circumstances.

Senator Sarbanes. Then do you think you're going to end up being the fall guy?

Mr. Volcker. It's up to you and others, I suppose, as to how I get characterized in the end. I would hope and expect that we can enter into a long period of healthy expansion. That's what we're aiming to do. Nobody will know for sure until it happens, and if it does, nobody will be a fall guy.

Senator Sarbanes. Did you take the President's statement on Tuesday evening, "Right now with inflation as low as it is, 3.9 percent, there's room for interest rates to come down," as a criticism of your policy?

Mr. Volcker. When he read that statement I didn't know what to expect. I was very interested in what the next sentence was going to be. I found the next sentence quite reassuring in the sense that he pointed——

Senator Sarbanes. "Only fear prevents their reduction?"

Mr. Volcker. Exactly. I think interest rates are high. I've said this repeatedly. Interest rates are high relative to the current rate of inflation; more important, they are high relative to what I think the future has in store. Unfortunately, that's only one man's opinion.

Senator Sarbanes. With respect to future deficits, those extending into the outyears, would you say that the increase in defense spending has contributed to the deficits?

Mr. Volcker. Any expenditure contributes to deficits.

Senator Sarbanes. Including defense spending?

Mr. Volcker. Including defense spending.

Senator Sarbanes. Would you say that the tax cuts have contributed to the deficit?

Mr. Volcker. Yes. The deficit reflects the combined impact of all revenue and expenditure measures.

Senator Sarbanes. Then you wouldn't agree with the assertion that the deficits we face are not rooted in defense spending or in tax cuts; they are in part rooted in both those things, aren't they, as well as in other things?

Mr. Volcker. I don't know what the word "roots" means in the context he was analyzing——

Senator Sarbanes. Well, we don't have Alex Haley here to tell us.

Mr. Volcker. That's right. Obviously the deficit reflects the totality of all these things. If you analyze it in terms of what has changed—what has caused the deficits since year "a" or "b" or ""c"—that's another way to look at it.

Senator Sarbanes. Now let me turn to the international area. Would you say that the Congress, as part of increasing the IMF quota, ought to establish some procedure, either at the IMF or elsewhere, review and screen private bank loans to governments to insure against a situation in which these loans are simply extended and extended and extended? Your own testimony, as I read it, says this has been done too much and too long, so that now we face a difficult situation. Then, of course, everybody says, "Well, we can't allow what would otherwise be the normal consequences of such conduct to take effect because the disturbance to the international system would be too great. We can't allow large countries to go 'bankrupt' and the banks to fail." Then we have to move in and provide the means to recoup or remedy that situation.

Don't we need a procedure to assure that this situation is either not going to develop at all or will certainly be spotted at a much earlier point than is now the case?

Mr. VOLCKER. I think the situation obviously raises questions along those lines. Whether it should culminate in some congressional action, I think it is far too soon to say. Certainly it provokes further review of our own regulatory/supervisory procedures in this respect. I think it raises a relevant question internationally, as you suggest in alluding to the International Monetary Fund. These problems are not unique to American banks. It's part of an international competitive situation. The prophylactic side of this is a very relevant kind of question and consideration, and we are certainly looking at it and will look at it more intensively and report to you our thinking and conclusions on this score.

Senator SARBANES. Do you expect to testify before the Congress on the IMF quotas issue?

Mr. VOLCKER. I testify next week before the House Banking Committee and 2 weeks following that, before the Senate Banking Committee.

Senator SARBANES. Would you be in a position that quickly to make some recommendations?

Mr. VOLCKER. I don't think I would be in a position that quickly to make some recommendations.

Senator SARBANES. Well, then, Congress might be moved to act without the benefit of your counsel. I must say frankly that I don't see how the Congress can go on simply boosting these quotas without establishing some procedure that will provide reasonable assurances against this situation recurring in the near- or mid-term future. It would not be sensible or prudent. I recognize we have to address the situation with which we are confronted, but to leave ourselves completely open to a repetition of the problem later on does not seem to me to be sensible public policy.

Mr. VOLCKER. Let me point out a couple of things. I'm not at all sure—although obviously it's something to look at—whether specific congressional action will be necessary. You may want to give us some general kind of instructions. It may be just a matter of raising our consciousness. Our consciousness has been quite high all along, I might say. The IMF legislation is not before you. I will be testifying, I believe, before that legislation is before you. It's an item for prompt action, but not immediate action. There is some time to come back with more specific suggestions.

Let me also give you the other side of the dilemma, if you will. I well recognize the kinds of concerns you have, and, of course, I share them. On the other side, we don't follow the approach of dictating to banks where they make loans in this country or elsewhere. Obviously that raises a lot of philosophical as well as practical issues in dealing with this kind of problem. You have to balance appropriate restraint and supervisory concern with the inherent market judgments of the institutions involved; how to strike that balance is the heart of the problem.

Senator **Sarbanes**. I'm limiting my concern to the market judgments of the institutions only as they relate to loans made to governments because in those cases the institutions end up not having to take the normal consequences of loans in default. When the borrower is a government, default is perceived in a different light than the default of a private borrower.

Mr. **Volcker**. It's partly that and partly the sheer scale, I suppose, that's involved here, but I think your basic philosophical point is that the Government accepts a certain responsibility for protecting the stability of the financial system. Accepting that responsibility, in my mind, does imply a certain concern about developments within that system that could lead to a crisis and to consideration of supervisory and prophylactic measures in that connection. As a matter of philosophy, I have no disagreement with you. As a matter of practicalities, this particular area will require some rethinking. I have no present judgment as to whether or not it requires congressional action.

Senator **Jepsen**. Congresswoman Holt.

Representative **Holt**. Thank you, Mr. Chairman.

Chairman Volcker, you have explained this over and over again in your testimony today about the interest rates, but I have some real concern about it because I think what we all want to see is interest rates down on a stable basis. This chart disturbs me because it refers to real prime interest rates and I feel that the real rates of interest on long-term loans are, as you said to Senator Roth, not simply the difference between nominal rates and inflation. They are the difference between the interest rate and the expected rate of inflation.

Mr. **Volcker**. That's right.

Representative **Holt**. Well, what's the real rate of interest today on the 90-day and the 6-month Treasury bill? Yesterday's bills had a rate of about 8 percent and inflation was about 5 percent. What is the real interest rate today?

Mr. **Volcker**. I can't answer that question with precision. I can tell you down to the last one-hundredth percent what the bill rate is at this moment but I can't tell you down to the last one-hundredth percent what the inflation rate is at this moment. It seems to be a kind of common impression, judging from some surveys that I have seen and questions that I ask of visitors often, that it's 5 or 6 percent. If you ask people what they take the underlying inflation rate to be at the moment—not what last month's Consumer Price Index was, we all know that—but what the continuing inflation rate is, the typical answer is in the 5 or 6 percent area. If the inflation rate is 5½ percent and the 3-month Treasury bill rate is 8, you would say the real interest rate of Treasury bills is 2½ percent. If the underlying inflation rate is 5, real interest is 3. You're in that neighborhood.

The prime rate is considerably higher and you get a higher real prime rate. With the 5 percent inflation rate, and a prime rate of 11 percent, you get a 6 percent real interest rate, which is higher than the historic average. I noted that bank rates over time may be affected by the degree of concern, nervousness, feelings about stability in the system generally. I might note that right now, that while interest rates are important in terms of public policy, I think it's fair to say that consumers seem to love high interest rates when it comes to making a deposit. These new deposit instruments have just been introduced, Congress provided that authority last fall, and the banks have been competing extremely actively for these new deposits. A number of banks have paid 11 percent or more for the new money, and they are probably feeling a little squeezed between what they're paying for the new money and their lending rates.

My impression is that consumer rates have begun to come down quite rapidly now, but certainly, Mr. Chairman, I think your observation was correct, they were rather stickly and sluggish for a while and probably still are. This very active competition for deposit money——

Representative HOLT. Isn't the T-bill rate a better test of interest rates than looking at the prime rate?

Mr. VOLCKER. The T-bill rate is more of a pure interest rate. It doesn't directly involve all these other considerations.

Representative HOLT. Another thing that has concerned me ever since I have been involved in budget matters is the dollar, the overvalued dollar. We have a lot of pressure on the international situation, protectionism and that kind of thing, because we are all so deeply concerned about the unemployment rate today. If we strengthen our economy, which I feel that we are doing and I have confidence in it, even though we bring the interest rate down, won't the dollar continue strong? And I'd like to hear your comments on the appropriate monetary policy for dealing with the overvalued dollar.

Mr. VOLCKER. We had precisely that situation during most of the fall. American interest rates were dropping quite rapidly and there was very little response in terms of the exchange rate. The exchange rate remained high for months while interest rate relationships were changing quite radically. You tend to associate high interest rates here and lower interest rates elsewhere with a strong dollar; I think that is a factor, but it is not the only factor as that demonstration last fall rather conclusively shows. I don't have any magic answer to that.

As I suggested in responding to Congressman Hamilton earlier, I think in more normal circumstances, in circumstances in which expectations are not so volatile and in which there is relatively more confidence in the inflation outlook and business conditions are more stable, there are opportunities to moderate some of the more extreme fluctuations in exchange rates through monetary policy or otherwise. That's got to be done in the context of maintaining a policy that's appropriate with all our domestic considerations; at times you may have a little flexibility.

Representative HOLT. Well, when you're deliberating about monetary policy, does the dollar enter into it or do you completely exclude that?

Mr. VOLCKER. I don't think you can exclude it completely, but the degree to which it enters depends upon all the circumstances. I think it's fair to say that during the past couple of years, as a matter of priorities, if you will, conflicts appeared between what might have been desirable in terms of pressures on the dollar and what seemed necessary domestically, and those decisions had to be tilted heavily toward changing the inflationary momentum.

I must say I found among my colleagues abroad a good deal of understanding of that situation. They didn't like all the consequences in terms of the exchange rates, but I think by and large they understood where the priorities had to lie, not just in our own interest but also because they thought they had a very large stake in dealing with the American inflation, that they couldn't deal with their own inflation over a period of time unless the United States dealt with its inflation as the world's leading economy.

I don't want to suggest that I think that policy was not consistent with the interest of other countries broadly interpreted, but it took a long-range view of the matter, in the sense that everybody had a stake in giving priority to the inflation problem during that period.

If we can get over that problem, get it under control—it will always take vigilance, but when it's not quite so urgent—there is a little more flexibility.

Representative **Holt**. Thank you, Mr. Chairman.

Senator **Jepsen**. We have a couple of questions that I know of. I would ask that the members of the committee, if possible, could state their questions and have the Chairman reply for the record, if it fits. If it doesn't, if it's a question the Chairman can reply to in a very abbreviated form, I'll go first to Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman. I'll be as brief as I can.

Mr. Volcker, the essence of the administration's proposal for getting interest rates down—certainly fiscal policy could do something—has been to encourage investments through progressive income tax cuts designed to increase savings and therefore increase investment. While this has helped I presume to some extent, along with the recession, to bring interest rates down, it has not increased investment. It has not increased investment for a very obvious reason. As Senator Roth has pointed out, we're operating now at a stage where we have enormous unused capacity. Why should anybody invest in new equipment or new plant when he has a third of his plant lying idle? It seems to me that the problem is what we do about increasing consumption. Until we increase consumption, we are not really going to be able to move on a sustained basis out of this recession and we won't get the kind of investment we need.

Shouldn't we be taking steps to encourage consumers to get back into the marketplace? Hasn't there been too much emphasis in trying to shift behavior away from consumption toward savings and isn't that a sterile concept in view of the results?

Mr. **Volcker**. I think the kind of measures that you're talking about to stimulate investment are basically structural measures that can't be just turned on or off to meet short-run objectives. In order to be successful, you can't as a practical matter, try to influence investment in the short run. I think those kinds of measures have to be judged in terms of their long-run effects, and they ought to be changed only quite cautiously and not because of a particular business situation.

If I begin at the other end, if you ask me whether it is not true that consumption has to lead the way out of this recession and whether investment will lag, I agree. I think that's what will happen through the mechanisms of the marketplace.

Senator **Proxmire**. Yet all of the policy we're following as far as the social security is concerned, as far as pay of the military, pay of civilians, we're holding down income and we're preventing consumption, are we not?

Mr. **Volcker**. I don't believe so in an overall sense. Whether deliberately or otherwise, the massive overwhelming policy that you're following on the fiscal side is a great big deficit, and a deficit does pump out purchasing power to the consumer and is sustaining income and sustaining consumption. That overwhelms all these other measures in the short run. That is the basic thrust of what's going on, great big deficits holding up purchasing power and supporting consumption.

Senator **Proxmire**. Well, I wish I had time to pursue that. Let me ask one other question which we can get a very quick answer to.

This question was raised by Senator Sarbanes toward the end, but I'd like to point out, as you know, that the nine largest banks in this country have 130 percent of their capital loaned out to Mexico, Argentina, and Brazil, which seems to me to be an alarming situation. We have a limit, as I understand it, from 25 years on the Banking Committee—we have a limit that a bank can loan to a domestic borrower, isn't that right?

Mr. **Volcker**. To an international borrower, too. You just raised it last year.

Senator **Proxmire**. Well, we limited the domestic borrower to something like 15 percent. I just wondered if we shouldn't pass legislation limiting exposure by any one bank in any one country.

Mr. **Volcker**. Well, that's one possible approach. It's, of course, a pretty arbitrary approach. I was not very happy about Congress increasing the single borrower limit last fall, you may recall, so I think that's a relevant approach. I'm not sure it's a preferred approach. I would not support it at this point because it is arbitrary; lending 10 percent of your capital to Canada is not the same as lending 10 percent of your capital to Costa Rica. They are quite different situations for quite obvious reasons. How can you reflect those differences in necessarily arbitrary limit of that sort?

The question is a relevant one and one upon which we are deliberating. I think there are, in all likelihood, better ways of exercising the kind of restraint that you and Senator Sarbanes are concerned about, but that's a preliminary judgment.

Senator **Proxmire**. Thank you, Mr. Chairman.

Senator **Jepsen**. Senator Roth.

Senator **Roth**. Mr. Chairman, with one exception, I would like at this time to submit my questions in writing. Mr. Volcker, I would like to ask you, since your term is coming to an end, whether you think there would be any merit in having the Chairman's term coterminus with that of the President. The reason it has seemed to me to have some value is that it avoids the suggestion that there's a conflict between fiscal and monetary policies. I do think one of the problems in our Government is trying to develop a cohesive economic policy. Under our Constitution we're so fractured anyway that perhaps this might be a step in the right direction. Would you care to comment?

Mr. **Volcker**. I think you've got so many questions for consideration. You've got the point you just made in the sense of coordination, communication, and enhancing that by providing an opportunity for a new President to appoint a new Chairman of the Board. On the other side, you've got long-established tradition and the desirability of a degree of independence, of not catching the Federal Reserve up into a short-term political process and short-term political considerations.

The Federal Reserve has upon occasion—and I think this is a reasonable approach—attempted to compromise those considerations by suggesting that the terms be made not coterminus but alined, giving the President the opportunity to appoint a new Chairman some time after he has taken office—not immediately upon taking office but say a year later. Legislation to that effect has been proposed. The situation happened to be that way by accident for many years, because someplace along the line a Chairman got appointed a year after the President took office and it continued that way for at least several decades. In practice, what happened by accident was, I think, a practice that was quite reasonable.

Senator ROTH. Thank you, Mr. Chairman.

Senator JEPSEN. Chairman Volcker, I'd like to clear up a point here regarding the status of the Federal Reserve Board. That Board was established in the wisdom of Congress as a very independent board. Is that your understanding?

Mr. VOLCKER. Yes, sir.

Senator JEPSEN. And do you have, by statute, any direct accountability to the administration or to the Congress?

Mr. VOLCKER. We have no accountability in a statutory sense to the administration. We obviously have accountability to the Congress, which created us and asks us to report with frequency and to describe our plans and intentions; that's all laid down in statute and practice.

Senator JEPSEN. So you have a direct accountability to the Congress by statute but not to the administration?

Mr. VOLCKER. That's correct.

Senator JEPSEN. I wanted that to be clear in the record. Now you have a 14-year appointment, is that correct?

Mr. VOLCKER. A Governor's appointment is 14 years. My term as Governor is about 12½ years because I am filling an unexpired term.

Senator JEPSEN. In the makeup of membership, do we have agriculture specifically represented on that Board?

Mr. VOLCKER. Not at the moment. Now when you say specifically represented, without splitting hairs, I think we should have a variety of viewpoints on the Board, and we try to avoid any suggestion that a Governor represent an "interest," as opposed to being experienced in an area.

Senator JEPSEN. I appreciate that and I know recommendations for geographic representation and reflecting a cross-section such as agriculture, are mentioned. There has been a feeling—and I think with reason—that the agricultural community has not been—even in the common prudent sense—represented on the Board and——

Mr. VOLCKER. In the past there has been a Governor who's had particular experience in the agricultural area, but that is not the case today.

Senator JEPSEN. As of today?

Mr. **Volcker**. That is correct.

Senator **Jepsen**. I thank you very much and as I said in the beginning that your answers would be straight talk and that's what we've gotten from you. It's been very refreshing. I thank you very much for your patience and your courtesies.

The committee will stand in recess.

[Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Monday, January 31, 1983.]

[The following information was subsequently supplied for the record:]

Response of Hon. Paul A. Volcker to Additional Written Questions Posed by Senator Roth

Question 1. Why does the Fed give so much attention to the size of the deficit in setting its policies when the real problems in the economy are so acute?

1. High unemployment.
2. Widespread business and farm failures.
3. Severe foreign trade problems.
4. Need for international liquidity.

Answer. The Board and the Federal Open Market Committee attempt to give due attention to all significant developments in the economy and financial markets when setting policy. We are certainly mindful of the serious problems you cite. The question is what mix of policies will be most conducive to resolving them, and specifically, what can monetary policy do, given everything else that is going on. As we consider credit market conditions, however, and the continuing high level of interest rates that is inhibiting satisfactory economic performance, we see the massive federal presence as a borrower as a particularly serious concern. Achievement of a sound, balanced economic recovery that will be sustained in the years ahead—something that is needed to solve many of our economic ills—would seem to require decisive action to turn back the tide of federal red ink.

Question 2. Why are you so afraid of inflation today when all evidence suggests that deflation is possibly more of a threat?

1. The oil glut and declining oil prices.
2. Crop surpluses and weak farm prices.
3. Low utilization of industrial capacity.
4. Soaring imports.
5. The effect of unemployment on wage rates.
6. Absence of speculation in real estate.

Answer. To be sure, there are points of vulnerability in the world economy, and prices in some markets remain weak, but there appears to be little threat of actual deflation—that is, an appreciable decline in the general price level. Certainly, the Federal Reserve would not permit the sort of monetary contraction that was an ingredient in the last significant deflation in the 1930s. As for inflation, although we have made real progress in reducing the pace of wage and price increases, we can't say that inflation is dead. In the past few decades sustained disinflation has not been achieved in an environment of economic expansion, and as a consequence there is a widespread skepticism about whether inflation will in fact be held down in the period ahead as labor and product markets show renewed vigor. This is another factor holding interest rates higher than they would otherwise be. A sense that governmental policies will maintain needed financial discipline is crucial to overcoming that skepticism and thereby removing a key obstacle to the kind of prosperity we all would like to achieve.

Question 3. Why do you believe that any move toward easier credit must inevitably be followed by more and more monetary stimulation and that there is no other way to reverse such a move? Why not assume that others in your position sometime in the future will act responsibly if there should be a need to tighten credit again?

Answer. I would not assert that some "easing" move today would necessarily imply excessive monetary stimulus over the longer run. However, we must recognize that the ability of the Federal Reserve to pursue successfully a policy of "fine-tuning" is limited by the lags and uncertainties characterizing the linkages in the economy. Furthermore, there is always the possibility—particularly in the environment of skepticism, if not cyncism, about governmental policies I noted above—that policy actions may be misinterpreted, with unintended and counter-productive market reactions. All things considered, it seems to me that a premium must be placed on achieving a reasonably stable, longer-range thrust to monetary policy that is consistent with sustainable economic growth over time along with diminished inflation. I would hope that the System would maintain such a policy in the years ahead. But, in terms of immediate market reaction it does not matter so much what you or I might hope, but what the market will expect. Market expectations of an upsurge in inflation or continued pressure on the Federal Reserve to permit more rapid money growth to take care of the budget deficit would lead to a market reaction in exactly the opposite direction of what you and I want.

Question 4. Have you considered the possible benefits from a dramatic move to bring interest rates down substantially?

1. A much more vigorous housing recovery.
2. Stronger auto sales.
3. A return to inventory rebuilding.
4. A lower dollar which would expand exports and reduce imports.
5. A more rapid increase in jobs.
6. Increased federal revenues and a smaller deficit.

Answer. A reduction in interest rates—particularly a durable reduction—would have many desirable effects. I believe that the Federal Reserve has been pursuing policies that contribute to the achievement of such a sustained reduction, but there is a major obstacle in the fiscal policies that have put the federal government in direct competition with private borrowers for a limited pool of savings. A "dramatic move" by the Federal Reserve to push down rates in these circumstances likely would find its force dissipated before long in heightened inflation expectations and no improvement—and perhaps a deterioration—in the balance of pressures in the market for credit. A "dramatic move" on the fiscal front, with monetary policy unchanged, could have a much more salutary effect on the interest rate outlook.

Question 5. Have you considered that time may now be against you in your efforts to reduce interest rates gradually? Our economic problems may be reinforcing each other than diminishing?

Answer. It must be remembered that satisfactory economic performance, not any particular level of interest rates, is the ultimate objective of policy. The Federal Reserve seeks to foster a financial environment conducive over time to raising economic activity and price stability. I believe there are signs of progress on both those fronts, with evidence mounting that business activity has turned upward—partly in response to the sizable interest rate declines to date—and that underlying trends of inflation are moderating. I would expect that as we make further progress in the disinflationary process—as we must if we are to have a strong and sustained economic expansion in the years ahead—interest rates will tend to fall further.

Question 6. Why are you concerned about the reaction from the financial markets if you moved more vigorously to reduce interest rates? Any adverse reaction would have to be temporary because you control the supply of credit, they don't.

Answer. One certainly can't ignore the realities of market perceptions and psychology, but there are other fundamental reasons over the longer run for being wary of moving excessively vigorously to push interest rates down. If, for example, the Federal Reserve were to pour reserves into the banking system in an effort to force interest rates downward, there would be a tendency for those reserves to be translated into faster monetary expansion—which, if pushed too far, would result in inflationary monetary growth. In any event, it is not entirely accurate to say that the Federal Reserve controls the overall supply of credit. We can influence indirectly developments in both the supply and demand for credit through our reserve supplying and absorbing actions and use of our other policy instruments, but ultimately it is the borrowing and lending decisions of households, businesses, government, operating directly or through financial intermediaries that determine the structure of interest rates.

THE 1983 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, JANUARY 31, 1983

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 6226, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen and Mattingly; and Representatives Hamilton, Obey, Holt, and Lungren.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; and Robert J. Tosterud and George R. Tyler, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Welcome, Secretary Block. I would judge, Mr. Secretary, you know better than anyone the breadth and the depth of the economic problems that U.S. farmers and ranchers are facing today. Your Department's recent farm net income projection of $15 to $19 billion in 1983 predicts a fourth consecutive year of severely depressed earnings for the farm sector.

I firmly believe, however, that the marked deterioration of the economic condition of agriculture during the previous 3 years and the Soviet embargo decision of your predecessor almost exactly 3 years ago is much more than just a coincidence. You know, if there's an issue before this Congress which can and has to be addressed in a totally bipartisan fashion, it's the financial plight of the American farmers.

With Vice Chairman Hamilton's full agreement and support, I want to pledge to you, Mr. Secretary, the commitment of this committee to a constructive bipartisan treatment of agricultural problems.

It is important that this Congress marshall whatever resources may be available to quickly and effectively address the economic future of American agriculture. It is our intention that the Joint Economic Committee serve as a proving ground for the development and appraisal of desperately needed new ideas and approaches to reversing the economic deterioration of the farming sector in our national economy.

I'm sure you will join with me, Mr. Secretary, in informing and reminding everyone that agriculture in one form or another accounts for 20 percent of this Nation's gross national product and labor force and that a full and lasting economic recovery will not be realized by this country as long as agriculture remains depressed. And that's not a threat; it's a fact.

I look forward to your testimony this morning and we have a number of pressing things that I believe really need airing and we need to get them out in front of the public for both comment and input and also to alert some of our fellow folks in the bureaucracy back here that we've got some problems that need attention now. We don't have the luxury of having another 18 months of committee meetings or even another 3 months of committee meetings.

There are some things that have to be addressed now. The IRS has to get with it and realistically get some ruling out for our PIK program so that this program can go along as we had hoped and planned for and as the agricultural community in this country had hoped and planned for. The dragging of feet of the IRS on the ruling of how these PIK payment-in-kind things are to be handled administratively and taxwise is just not acceptable and we'll discuss more of that later this morning.

At this time I would like to recognize and yield to the distinguished vice chairman of this commitee, Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Just let me add a word of appreciation for the Secretary's appearance here this morning. We are delighted to see you and we look forward to your statement and the opportunity to ask a few questions. Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Mr. Chairman, I just want to say I'm delighted, being someone from an urban area—I think the only agriculture I have in my district happens to be that which is leased out at the weapons station. I guess I'm here as much for an educational experience for myself, but also to ask some questions with respect to agriculture and its tremendous position in California economy, and I'm just very pleased to be able to hear the Secretary.

Senator JEPSEN. Thank you, Congressman Lungren.

Before we hear from our witness, I have received an opening statement from Senator Abdnor to be included in the record, without objection.

[The opening statement of Senator Abdnor follows:]

OPENING STATEMENT OF SENATOR ABDNOR

Welcome, Mr. Secretary, I am extremely pleased to have you added to this committee's series of annual hearings. I am confident that your views will contribute greatly to our understanding and appreciation of the role agriculture plays in our national economy and the challenges this industry presently faces.

I have been trying to convince people for 2 years, Mr. Secretary, that U.S. agriculture's income problems are more symptomatic of a fundamental structural change in the industry than a cyclical, temporary downturn. U.S. agriculture is now a mature industry in the global sense; much like textiles, steel, and automobiles. While we still hold the prominent position of grain producer and supplier in the world, at one time, we also held similar status in textiles, steel, and automobiles. Agricultural technology—like automotive technology—is easily transferable from one country to another. In many instances this technology can compensate for a country's climate and relatively poor soil productivity.

In addition, trade practices and subsidy schemes of other governments representing their food producers have dramatically changed the competitive environment of world agricultural markets. The world food market is no longer ours for the taking as was the case during the 1970's. Our Government farm policy and program perspective needs to be modernized, Mr. Secretary. We need, in the full sense of the term, an international farm policy; one that recognizes and is capable of dealing with the realities and challenges which will face U.S. farmers in the world market place in the 1980's.

While I fully support supply control measures, I am very concerned that we do not seem to be willing to make a comparable commitment to expanding exports. Obviously, our success at reducing supplies can be offset by our failure to expand exports leaving price-depressing U.S. stocks unchanged. This is the road to U.S. agricultural oblivion in my judgment.

Therefore, I strongly urge the administration to support the Agricultural Export Market Recovery Act, which I will shortly be introducing.

This act will establish a direct and vital link between crop production and the Government's effort to expand exports. It recognizes the mutual obligation of farmers and the Government to contribute to the reduction of price-depressing surplus grain stocks. Clearly, the quickest and most effective way to eliminate burdensome and costly surpluses is to simultaneously reduce production and expand exports.

The act calls upon you, Mr. Secretary, to draw upon funds already appropriated to the Commodity Credit Corporation for export promotion activities but as yet unexpended. The act causes funds to be drawn from this CCC account in the same amount as payments are made to farmers participating in the paid land diversion program. That is, for every dollar paid to farmers to divert land out of production a dollar will be used to promote and expand commercial export sales. Importantly, the magnitude of the Government's export market promotion resources will be in direct proportion to farmers' participation in suppy control programs.

In addition to this proposal being a needed further incentive for farmers to reduce output, our foreign competitors will view our unilateral decision to reduce production in a totally different light—the more successful we are at reducing production the greater our capability to respond to market opportunities and challenges.

The act, in combination with current farm programs, constitutes the fundamental elements of a much overdue U.S. international farm policy. I look forward to your remarks.

Senator JEPSEN. Mr. Secretary, you now may proceed and welcome again.

STATEMENT OF HON. JOHN R. BLOCK, SECRETARY OF AGRICULTURE, ACCOMPANIED BY WILLIAM LESHER, ASSISTANT SECRETARY FOR ECONOMICS

Secretary BLOCK. Thank you very much, Mr. Chairman.

Initially, I want to express my appreciation for your remarks and your commitment to a bipartisan effort to address the problems we face in agriculture as we look for solutions. This will be a very constructive and I assure you this will be the approach that I will be taking.

I also appreciate the opportunity to appear before your committee today. I have on my left Assistant Secretary for Economics, Bill Lesher, and he is here to assist me in answering some of the questions.

The agricultural sector is going through a difficult period of adjustment and the near-term outlook is not as bright as I would like to see. However, in dealing with the current situation, I think it is important to realize that the factors affecting the farm economy are complex, and, for the most part, beyond the direct control of anyone. More importantly, we must begin to face the fact that many of the traditional farm policy tools are too inflexible and not as effective as one would like in dealing with the realities of U.S. agriculture's current position in U.S. and world economies.

Mr. Chairman, in my remarks today I am going to first review the developments which have shaped our current farm problem. I have a few slides[1] which I would like to share with you on this subject. Then I would like to discuss some recent actions taken by President Reagan to put agriculture back on course. Finally, I would like to share a few of my thoughts on the implications of the changing environment in which agriculture finds itself today.

Clearly, the most important factor currently impacting the agricultural outlook is the general economic condition of the world. While many events can impact agriculture, ranging from weather to new technologies, none has the pervasive impact of a global recession. Agriculture became dependent upon exports to sustain its expansion over the past decade and the evolution of that dependence is the basis for the shock waves now being felt throughout the food and fiber system.

The forces that have shaped this increasing interdependency of agricultural conditions and general economic conditions are longer term in nature. A review of these factors underscores the difficulty in counteracting them or offsetting their effect on farmers in the near term.

We have a series of slides here that I will go through and comment on briefly as we go through the slides.

[Slide.]

Today's farm problem. Today's farm sector is plagued by large supplies plus weak demand and that, of course, equals low prices.

[Slide.]

The next question is, Why are crop supplies so large?

[Slide.]

There are many factors that have propelled production upward over the past decade. During the 1970's we had relatively easy credit, heavy capital investment, rising prices and price supports, booming farm exports, acreage expansion, yield-boosting technology and excellent weather the last two years.

[Slide.]

If you look at the chart there you can see that the amount of debt in agriculture has grown steadily over that period of time. I'm not saying it's good. I'm not saying it's bad. I'm just saying it's a fact of life. We have expanded our financial obligations in the industry.

[Slide.]

Capital investment was very heavy during the 1970's. New technologies in agriculture were in a period of gearing up, and a lot of money was spent on capital investments.

[Slide.]

Prices and loan rates trended upward and it's important to look at this. You can see that the season's average farm price has been generally heading upward. We've stairstepped this loan rate underneath it providing the safety net for agriculture and over that period of time and recently this safety net has risen high enough to interfere with the market. You can see in 1982–83 we're starting to have price supports above the market. This is a problem for us and I'll talk more about it later.

[Slide.]

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[1] The slides presented by Secretary Block may be found at the end of his prepared statement.

Agricultural exports have soared during this period of time. Export value and export volume increased a tremendous amount.

[Slide.]

Crop acreage in the United States has exploded: 100 million new acres have come on line and increased production significantly.

[Slide.]

We've had technological improvements over the years that have provided increases in yield and also during those years you can see where we had some weather constraints on different occasions. In 1970 it was the corn blight. In 1974 it was a late spring and early frost, and in 1980 it was a nationwide drought.

[Slide.]

The weather the last 2 years in 1981 and 1982 has assisted in pushing our production to new records.

[Slide.]

Now the question is, having looked at what gave us a great increase in production, why is demand so weak today? What's the problem?

[Slide.]

Weak demand is a global problem. We don't live in a vacuum in agriculture. We live in a world market. We have widespread recessions around the world and rising value of the dollar, instability in Eastern Europe and Mexico and other countries, embargo related losses, East-West political tensions, and unfair trade practices by some of our competitors.

[Slide.]

Widespread recessions around the world. The gross national growth rate in industrialized countries has dropped from 4 percent almost down to zero and in less developed countries it's been on the decline.

[Slide.]

The rising dollar has made the United States corn exports less attractive in the world market. As you can see, the price that farmers receive is that solid line. Look how low it is. This is back in September of last year. But notice that the price importers pay the dashed line—is very high. It's because the dollar has been so strong. That's put us at a disadvantage competitively.

[Slide.]

Instability in the world has reduced our farm exports. U.S. farm exports to Mexico did drop in 1982. We look for Mexico to come back this year, but it's because we're making ample amounts of credit available to them to satisfy their needs for food. In Eastern Europe, we have a number of countries there that are in very, very difficult economic times and not a very good economic risk and you can see the exports into that region were cut in half in 1982. They will probably be lower again this year.

[Slide.]

The grain embargo in 1980 to the Soviet Union cut deeply into our potential exports there. What really happened is apparent, when you look at the chart, you can see the peak in 1980 when the embargo took place. Since then, the needs of the Soviet Union have expanded very rapidly, but someone else has gone in and made the sales. United States exports have been at least fairly stable. We did not enjoy that growth in the market as we should have and could have. We did come back last year and sell some 14 million metric tons which is about 35 percent of the market. We had 70 percent at one time, however.

[Slide.]

The European Community has been subsidizing exports, using money from their Treasuries to buy markets. As you can see, the changes since 1976 to 1980 and the amount of money they're spending now on export subsidies is some $7 billion. Their exports have also exploded over that period of time. They are becoming a major factor in the export of agricultural commodities around the world and, of course, the only way they can export in the world market is by buying that market with subsidies.

[Slide.]

The farmer is under stress today from weak world demand, reduced exports, soaring stocks, depressed farm prices, 3 years of poor farm income, a drop in farmland prices, costly credit, and solvency problems. All of this has happened in the face of skyrocketing government expenditures for agriculture. The trendline on world demand is the dashed line and you can see that the actual demand line is dropping below the trend line for wheat and coarse grains. We're just not seeing the growth in demand that we have seen during the decade of the 1970's. In fact, it's almost level right now as no growth.

[Slide.]

The farm exports have dropped after a decade of constant growth. They have dropped in value more than they've dropped in volume. The volume is essentially flat. The value is down because the prices of commodities are down.

[Slide.]

We have enormously large grain stocks in the United States. The coarse grain stocks are the chart on the left and you can see the world stocks have shot up to record levels, at least record for the last decade, and the U.S. stocks really have been the ones that propelled the world stocks in the record range. In the case of wheat, it's growing also but it's not quite as dramatic as the feedgrains.

[Slide.]

Grain prices are depressed. The chart goes through October–November of 1982. We have seen some strength since then but not that much. And you can see how they have come down dramatically since the middle part of 1980.

Senator JEPSEN. Mr. Secretary, excuse me a minute. Why do you think that corn prices had that rather dramatic increase and were up around the $3.25 area there in the early part of 1980?

Secretary BLOCK. In the early part of 1980 there was a drought and the expectations were for shortages of grains, so the prices did go up substantially and the agricultural outlook in the fall of 1980 focused on tight world supplies of grain and strong prices. Strong incomes for agriculture were predicted for the next 2 years. It didn't materialize because of the variety of factors that we've talked about here today.

Senator JEPSEN. The drought was responsible for it starting up there in the very early part of 1980?

Secretary BLOCK. That's right, and it carried on through into the first 3 or 4 months of 1981 before it broke. Then they could see a big crop coming, interest rates were very high, the dollar was very strong, and production grew while demand became weaker.

Senator JEPSEN. Doesn't this point out, since we had an embargo and our markets were literally shattered—they went from moving rapidly and progressively upward and then hit bottom after the embargo—doesn't it indicate that the psychology of reports that are delivered either from the USDA or from various sources around the world with regard to supplies and so on have a great deal to do with the market and with the price setting?

Secretary BLOCK. They do but there's a whole series of reports that come from many sources. USDA is one of the most credible sources of reports of supplies and production that you can find, but there are other reports on production from private forecasters and once the industry realizes what the prospects are, they are going to adjust their bidding accordingly. This makes sense.

Senator JEPSEN. This dramatically reemphasizes the fact that as long as we have huge surpluses, as you indicated in the previous charts, and huge reserves, those long-range market makers, knowing that there are these huge reserves and surpluses, are just simply not going to increase the price of grain as long as we have those reserve surpluses.

Secretary BLOCK. That's the truth, Senator, and I'll cover that a little bit in this discussion too.

[Slide.]

Covering cotton, you can see that we are well below the target price on cotton and that means that the Government has to make up the difference between the market price and the target price. It's becoming very costly. The top chart shows the volume of production and the consumption. Even with the tremendous losses we suffered in Texas and Oklahoma because of the heavy rainfall, we still had more production than we have consumption, domestic and international. People aren't buying very many clothes today because they can wear the old ones a little bit longer and during these tough times there just isn't very much incentive to go out and buy a new shirt. The demand is not there.

[Slide.]

Milk production, you can see that it's continued to increase. The cost of the program is in the range of $2 billion now, and it's not going down.

[Slide.]

We have had 3 years of low farm income. If you look on the right-hand side, you can see the actual farm income has slid from $22 or $23 billion down to $18 billion. But in deflated terms, it's even lower. It's much lower in real terms because of how much that money would buy today.

[Slide.]

Now the Government is trying and has, through its programs that we have had in effect, made an effort to address the problems in agriculture. We have been as successful as we would like to be, but what's happened is we have spent a lot of money. In 1982 you can see the cost of commodity programs is more than double what it has ever been in history and it's 2½ times what it was in 1981. The cost of farm programs just has shot up dramatically.

The American farmers have become especially vulnerable to fluctuations in world trade and world market prices. That gets back to what Senator Jepsen was talking about. For the past several years, United

States and world crop production have set new records, but global demand for agricultural products has switched from a high-growth path an one of little or no growth.

U.S. farm exports dropped for the first time in 13 years during the fiscal year ending in September 1982. Volume dropped 2 percent below the previous fiscal year, but value plunged 11 percent because of lower prices. Corn exports were hardest hit dropping by 10 million metric tons and $3 billion in value.

The sources of strength in our agricultural exports have been eroded by a variety of factors: Weak economic conditions throughout the world, financial instability in a number of countries, the strong U.S. dollar, losses related to the Soviet embargo, continued East-West tensions, unfair trade practices by some of our competitors, and restrictive market actions by some of our buyers.

In addition to that, I would like to give an example which relates to the chart on the export subsidies. In the Middle East, the European share of the whole chicken import market rose from only 3 percent in 1964 to 46 percent in 1980. During the same period, the U.S. share of the Middle East whole chicken import market declined from 97 percent to 13 percent. In other words, they came in and gobbled up a huge amount of that market, a huge share, and we have been virtually forced out of the whole chicken market in the Middle East.

With the consumption of commodities depressed by deteriorating economic conditions for the last several years, rising production has caused stocks to accumulate sharply, particularly in the United States. We forecast that by the end of the 1982–83 marketing year, world grain stocks are likely to reach about 266 million tons, about 89 million tons higher than 2 years before. This would be equal to over 2 months' supply of grain for the world, the highest global stocks-to-use ratio in more than a decade. The measure of food security that these stocks would provide must be balanced against their lopsided distribution, since 155 million tons, or nearly 60 percent, will be located in the United States.

These levels of carryover stocks are simply too large for the United States to hold. They depress prices no matter how tight free stocks become. We have seen sharp reductions in free stocks in recent years as the farmer-owned reserve was activated to strengthen markets. However, prices responded very little since domestic and foreign buyers, aware of the large stock overhang, were taking hand-to-mouth inventory positions and delaying purchases until new crop harvest-time pressures could offset any tightening in free stocks. That's precisely what you were talking about, Mr. Chairman.

Clearly, the problems we face involve successive years of large production in the face of weak demand, resulting in the accumulation of huge stocks. Improved price and farm income prospects for future years will require that the necessary steps be taken as soon as possible to get supplies more nearly into balance with demand. It is essential that in taking action that we not fall victim to the temptation of simply legislating near-term prosperity through higher price supports or other rigid nonmarket actions that have been used in the past. Yielding to such temptation fails to recognize the realities of agriculture today and will only encourage farmers to produce more at a time when the market is strongly signaling the need for less.

Let's talk about putting agriculture back on course. Agriculture today is undergoing some difficult financial times. Farm prices are too low; net farm income is too small; the farm debt is too heavy; and interest rates on existing debts are excessive. These problems constantly highlight the current agricultural news. As you watch your television, you see it. The Farmers Home Administration is working closely with the American banking community, and with the farm credit system, to help farmers during this difficult period. Regardless of what has been said, there have not been massive foreclosures. In fact, during the 1982 lending season, only 844 foreclosures took place. That's 844 out of 270,000 borrowers at Farmers Home. That represents less than one-half of 1 percent, hardly what you could call massive foreclosures.

And if I may digress here just a moment from the prepared notes. I want to say as I've talked to farm leaders across the United States, they've made it very clear to me—and I fully agree with them—that any attempts to provide for a blanket moratorium on principal and interest which would cause the farmers to become less responsible for their debts and their obligations must be carefully reviewed. If we're stampeded into doing something on a blanket basis like that, what we will do for all of agriculture is to make the sources of credit less available to agriculture; there will be less money for everyone and it's going to cost more for everyone borrowing. The lenders to agriculture must realize that agriculture is a responsible industry and we're going to take care of our debts: And I would add that the vast majority of producers are paying their debts. They're standing behind their debts and they believe in maintaining the integrity of this industry. I don't want to see that integrity impaired and damaged by some action that would be foolhardy and would be certainly less than responsible.

Now obviously, agriculture's problems are not going to be solved quickly. I think it's very important to keep the recent actions taken by President Reagan and myself in the proper perspective. We are building a foundation upon which agriculture can expect to establish renewed prosperity and more stable economic conditions. This requires an understanding of the realities of the marketplace and the limitations of government involvement.

Farmers' No. 1 market is the domestic commercial market. The condition of that market depends on the strength of the economy. Thus, the first priority of Government is to help build and maintain a vibrant strong and expanding jobmaking economy.

We have a good start in the last 2 years. The 1980 inflation rate was 13½ percent and now it has been cut to about 5 percent. The prime interest rate of 20 percent or more in 1980 has been cut to 11 percent—and every 1-point drop in interest rates on the outstanding farm debt has the potential to raise farm income 10 percent. It shows how important interest rates are to agriculture. In December, the prices that farmers paid for all commodities—including services, interest, taxes, and wage rates—were 3.3 percent higher than a year ago, compared with a 12 percent increase in 1980.

Farmers' No. 2 market is the export market. While trade issues have and will continue to occupy a great deal of attention, it is important to remember that economic conditions are still the key factor in our export markets. Here again a strong U.S. economy is an important impetus to renewed economic growth abroad and a recovery in the export market for U.S. commodities.

At the same time, the rules of international trading are set by governments. So our Government has a responsibility to help American farmers capitalize on their efficiency by working to keep international agricultural markets competitive; to free up trade restrictions; and to counteract subsidized farm exports where American farmers must compete against foreign treasuries. That's the Government's job.

Where our Government is not successful in freeing up trade or removing obstacles, or reducing foreign export subsidies, then we need to aggressively protect our markets. We favor using a greater share of our available public funds in aggressive programs to expand exports. On January 11, the President announced a $1.2 billion "blended-credit" program—interest-free direct export credits blended with Government-guaranteed private credit—to expand agricultural exports through lower interest rates on those exports.

More recently, we completed negotiation of a million metric ton U.S. wheat-flour sale arrangement with Egypt. This is a major thrust in our attempt to aggresively compete for the Egyptian flour market—the largest in the world.

All of the problems of U.S. agriculture are not rooted in basic trade issues; and the resolution of such issues will not insure a return to prosperity for our Nation's farmers. But we don't think the American public wants the Government to sit by while our farm exports suffer. Every American has a stake in our farm exports, since those exports create a favorable balance of agriculture trade that compensates for our deficits in industrial trade. Every $1 billion of agricultural trade creates an additional $1 billion worth of U.S. economic activity. That means jobs—35,000 jobs for each additional $1 billion in exports. As an example, the wheat-flour sale with Egypt will generate $850 million in additional economic activity and it will create 8,000 jobs.

President Reagan, in recently signing the Commodity Futures Trading Commission Reauthorization Act, once again reaffirmed his strong policy of supporting farm exports. Our reputation as reliable suppliers in world markets has been tarnished only by past adminitrations, not by farmers and their ability to produce and be competitive. Provisions in the act firmly establish the sanctity of contracts that many of our foreign buyers had been concerned about in the past.

Until the demand for U.S. products recovers, it is clear that a production adjustment must be made. On January 11, President Reagan announced a payment-in-kind program for 1983 crops of wheat, corn, grain sorghum, rice, and Upland cotton. The basic concept of the PIK program is that farmers are offered an amount of commodity as payment-in-kind for reducing acreage, over and above the requirements of the acreage reduction and cash land diversion programs already announced for 1983 crops. Indications are that producers are finding the program attractive and significant acreages will be removed from 1983 production. I've talked this last week with my father and he said that pickup trucks were lining up outside the AFC office. We've heard a lot of discussion in this regard.

But let me sound one note of caution here, to digress once again from the text, to point out that we should keep in mind the danger of assuming ahead of time that we have a successful program. It's not successful until the signups are there, the producers are in the program, and they are committed to take the land out of production. As a farmer myself, I know farmers naturally like to look around and see what their neighbors are doing. We like to hope that the neighbor will do the job for us so we won't have to do it ourselves. We tend to always look upon the bright side of things and assume that things are going to be better next year.

And the note of caution I would sound is that there's an enormous risk if you think that you're going to let your neighbor take care of this problem we have in overproduction and oversupply, and the risk is that if your neighbor doesn't do it for you, prices could collapse next fall. We may not have good prices. Don't assume they'll be there until it's a fact.

Second, where will we store another huge crop? We don't have the luxury of surplus storage now.

And finally, the program offers some insurance against bad weather. We've had two years of tremendously good weather, exceptionally good weather. This year may not be quite as good. Take advantage of the program. I think there's an opportunity to avoid a lot of risks and with the tough times we presently have in agriculture, it's worth quite a bit to avoid some of that risk.

We don't expect to completely liquidate burdensome stocks in 1983–84, but we do see this program as a major step in bringing crop supplies into line with demand.

The PIK program has several appealing and unique features.

No. 1, production can be reduced and thus bring supply back into closer balance with demand.

No. 2, stocks can be reduced at the same time that production is cut back, lessening the overhang on the market at harvest next year and enhancing the prospects for a market-led recovery in farm prices and income in future years.

Third, the availability of market supplies will be maintained, and this is important for signaling to the exporters and importers that the United States fully intends to remain a reliable and consistent supplier when production adjustments are made.

Next, Government outlays for domestic programs should decline and with some of the increases we've seen we need to get a handle on this and get it under control.

Once again, the PIK program, unlike other emergency measures, is self-terminating. When excessive stocks have been worked off, it's self-liquidating. When the stocks are gone, the program is gone.

Farmers will have the same or greater net returns while stocks are being reduced.

This is going to help our soil and water conservation program in the United States.

Finally, storage space problems will be lessened.

This massive land diversion program, the expanded blended-credit program, contract sanctity and Government-arranged export sales must be kept in focus. They are all building blocks to insure that agriculture is in a position to share in the rewards that will come with renewed economic growth in the United States and the rest of the world. We've taken dramtic and innovative approaches to our current problems, but there should be no doubt in anyone's mind that a strong, market-oriented agriculture with minimum Government intervention is the final solution.

We still have some difficult times ahead but I am more optimistic than ever that we have programs in place which are going to permit our farmers to emerge from these difficult years in a strong, competitive position that will deliver lasting prosperity. However, I might add, we must be careful that in our desire to restore prosperity we recognize agriculture's interdependencies. That's what I'm going to talk just briefly about now, interdependencies.

The evolution of the economic conditions in the agricultural sector over the past decade has significantly altered the interdependencies of the sector. At the same time, it has reduced the effectiveness of many of our traditional commodity programs.

Agriculture is an integral part of the U.S. economy. It is vital domestically and to the international interest of the United States. Broadly defined, agriculture is the nation's largest industry with assets equal to about 88 percent of all manufacturing corporations. Agriculture also is the Nation's largest employer. The value added to farm products as they flow through the economic system amounts to 20 percent of the gross national product and requires the services of more than 23 million people, or about 22 percent of the labor force.

At the same time, American agriculture is a major force in world trade and makes a significant contribution to the U.S. trade balance. We now export the production from 2 out of every 5 acres we plant.

This expanded role played by American agriculture in United States and world economies has brought a growing interdependency which we are now only beginning to appreciate. I think factors such as floating exchange rates, the declining value of the dollar, the inflationary spiral of the 1970's, and excessive amounts of credit following the major crop shortfalls of the early 1970's may have let us see only the positive side of this growing interdependency.

Now agricultural supplies are relatively abundant, the dollar has increased relative to other currencies, and world economic growth has become stagnant. We are now seeing the other side of the coin and discovering that the traditional measures we have used in the past to rejuvenate the agricultural sector have had limited success. Let me point out that along the way we've spent a lot of money.

The agricultural economic system no longer has geographic boundaries that permit action and reaction in a vacuum. It is a dynamic system in which rigidity leads to imbalances. Actions taken in any sector of our economy or the economies of any of the major countries in the world now impact agriculture immediately. These are the realities that we all are beginning to understand more fully each day.

Examples of my concern over the implications of these realities for farm programs are readily available. Persistent upward ratcheting of our domestic support prices during the past inflationary spiral has served to encourage producers in other countries to increase production. This surplus production is then forced into the world markets. As long as the total market was expanding and the dollar was declining in value, this really wasn't that important. Now markets are not growing or are shrinking for a variety of reasons and we are finding it more difficult to keep our agricultural base fully employed. To make sure this does not become a serious issue, producers in this country, as well as around the world, need to feel market signals.

The 1981 Farm Act mandates that the target prices for wheat, feed grains, rice, and cotton be increased each year over the life of the bill. While these increases may have seemed fairly reasonable in the context of the rapid inflation of 1980–81, we have seen dramatic improvement in reducing the rate of inflation. The mandated increases in the target prices now provide incentive for production increases at a time when moderation is needed.

Production costs only went up 3 percent in 1982, and many input prices are now actually lower than 1 year ago. We must make sure that after stocks are reduced significantly, we do not have price supports and target prices that would get us back into the same situation we are in today. This is the reason we are seeking authority for the Secretary of Agriculture to freeze target prices and that would be at the level for this crop, which means in 1984 we would be seeking a freeze for the 1984 crop year.

Furthermore, we would look toward, for the 1984 crop year, reverting back to the standard loan rate which is provided for in the 1981 Farm Act. That would be $2.55 for corn and $3.55 for wheat. We must take every precaution to keep the grain sector in agriculture from falling into the same situation as dairy.

Dairy is an example of losing touch with our domestic markets through rigid price support levels not sensitive to market conditions. For the last several years, dairy farmers have been responding to rising milk-support prices rather than to actual demand levels. The program now costs over $2 billion per year. They have increased the dairy herd and production per cow in the face of excessive supplies. Now, under pressure to reduce milk output, they have three hard choices: To cut back production; to switch to other enterprises; or find work off the farm. No one likes these choices, but there are no alternatives.

Our farmers want the opportunities that the marketplace can offer, both domestically and internationally. They are willing to take the risks that are inherent in the market if it is free and fair. We must be certain the Government actions do not distort the signals the market is sending, while at the same time, providing support when the need arises. That's a delicate balance, I might say, providing support and a safety net when there's really a serious need, and at the same time not sending excessive artificial signals to increase production. We are taking some actions now to get agriculture back on course but we don't want to follow the same path that has led us to our current situation. This is the challenge that faces us over the next few years. With your help, in addition to others, we can get the job done.

Thank you, Mr. Chairman, for your willingness to listen to this presentation. It's a little bit lengthy, but describing the economic condition of agriculture is a complicated one.

[The prepared statement of Secretary Block, together with attached slides, follows:]

PREPARED STATEMENT OF HON. JOHN R. BLOCK

Mr. Chairman, I appreciate the opportunity to appear before your committee today. The agricultural sector is going through a difficult period of adjustment and the near-term outlook is not as bright as I would like. However, in dealing with the current situation, I think it is important to realize that the factors affecting the farm economy are complex, and, for the most part, beyond the direct control of anyone. More importantly, we must begin to face the fact that many of the traditional farm policy tools are too inflexible and not as effective as one would like in dealing with the realities of U.S. agriculture's current position in U.S. and world economies.

Mr. Chairman, in my remarks today I am going to first review the developments which have shaped our current farm problem. I have a few slides which I would like to share with you on this subject. Then I would like to discuss some recent actions taken by President Reagan to put agriculture back on course. Finally, I would like to share a few of my thoughts on the implications of the changing environment in which agriculture finds itself today.

The Evolution of the Current Farm Situation in Perspective

Clearly, the most important factor currently impacting the agricultural outlook is the general economic condition of the world. While many events can impact agriculture, ranging from weather to new technologies, none has the pervasive impact of a global recession. Agriculture became dependent upon exports to sustain its expansion over the past decade and the evolution of that dependence is the basis for the shock waves now being felt thoughout the food and fiber system.

The forces that have shaped this increasing interdependency of agricultural conditions and general economic conditions are longer term in nature. A review of these factors underscores the difficulty in counteracting them or offsetting their effects on farmers in the near term.

Increasing Exports Stimulated Farm Output Expansion

The tight world food situation of the early seventies triggered a decade of expansion by American farmers and increasing reliance on foreign markets, which today account for two out every five acres that our farmers plant.

U.S. farm exports tripled between 1971 and 1981, in response to rapid growth in the world economy and population. Farm exports were also enhanced by the declining value of the U.S. dollar during this period. Our own economy was generally buoyant, producing strong growth in domestic demand, especially for livestock products. Farm prices rose through the seventies and the underlying price support levels were ratcheted upward. These events, coupled with appreciation of the dollar, have elevated the domestic price "floors" beneath grains, cotton, oilseeds, sugar, and dairy prices.

With plentiful and easy credit and rising land values during the seventies, farmers found it advantageous to escalate borrowing and make heavy capital investments. Results were dramatic indeed. Between 1971 and 1982, farmers increased the area planted to principal crops--excluding hay--by more than 60 million acres. Heavier input use, availability of yield-boosting technology, and recent ideal weather have pushed yields to new heights. Crop production per acre today is 17 percent above that of a decade ago. The combined effect of expanded crop acreage and rising yields has been to thrust U.S. crop production upward by fully one-fifth over the past decade. Livestock production also expanded, rising by 7 percent over the period.

With rising prices and land values, farmers who borrowed in order to expand their operations tended to earn a better rate of return than those with higher equity. Rapid inflation in recent years fueled additional borrowing to cover annual production expenses. Consequently, farm debt has tripled in the last decade, and interest payments now account for one dollar in every seven that farmers spend for their operation.

This expansion was followed by a period of reduced incomes during the last three years. This has greatly increased the difficulty of making large adjustments in production in response to current conditions. For example, crop producers who have heavy debt payments to meet and large investments to protect have less flexibility to reduce production. Livestock producers cut output this past year in response to several years of unfavorable returns. Now livestock prices are up and feed prices down. Yet, apparently because many producers are financially strapped, it appears they are much more cautious about gearing up to expand production.

This recent period has also witnessed an unprecedented growth in Government expenditures intended as financial support to the sagging farm economy. Commodity Credit Corporation outlays increased from under $3 billion in FY 1980 to nearly $12 billion in FY 1982.

Global Demand Has Changed Course

American farmers have become especially vulnerable to fluctuations in world trade and world market prices. For the past several years, U.S. and world crop production has set new records, but global demand for agricultural products has switched from a high-growth path to one of little or no growth.

The world economic problems of the early eighties have had a depressing impact on consumption of agricultural products. For example, during the last two decades, global coarse grain consumption rose on average about 16 million tons per year as diets were upgraded with more animal-product foods. Yet, since 1979/80, growth in meat production has stopped and coarse grain consumption has nearly flattened out. World wheat consumption, which had increased by over 10 million tons annually during the pest two decades, has increased by only 10 million tons since 1979/80. Cotton consumption is in a similar situation, since mill use is sensitive to economic conditions. World soybean usage, however, has continued about on trend.

U.S. farm exports dropped for the first time in 13 years during the fiscal year ending in September 1982. Volume dropped 2 percent below the previous fiscal year, but value plunged 11 percent because of lower prices. Corn exports were hardest hit, dropping by 10 million metric tons and $3 billion in value.

The sources of strength in our agricultural exports have been eroded by a variety of factors: weak economic conditions throughout the world, financial instability in a number of countries, the strong U.S. dollar, losses related to the Soviet embargo, continued East-West tensions, unfair trade practices by some of our competitors, and restrictive market actions by some of our buyers.

The world is in the grips of recession. The industrial market economies barely grew in 1982, and the U.S. economy declined. Developing countries, important to agricultural trade, grew by about 2.3 percent in 1982, well below the 5.4 percent annual growth rate for 1970-79. Thus, more production is available in the face of weakened demand. As a result, prices have dropped and stocks have accumulated. Trade tensions have heightened and will remain so until the economic situation improves.

U.S. recovery will help stimulate other economies, but the process will take time. The industrial market economies may grow only around 1-1/2 percent in 1983, and developing countries by 3-1/2 percent. But even this stimulus to incomes, and hence demand for farm products, will be tempered by lingering high unemployment levels.

A large number of countries have had financial crises that have forced them to curtail food imports. The financial problems of Eastern Europe and Mexico have been the most devastating to our trade. U.S. grain exports to these markets dropped by over 40 percent (about an 8 million ton reduction) in 1981/82 and have recovered very little in the current season.

Foreign investors, seeking a haven of safety and high interest rates, have been helping drive up the dollar's value. Even though interest rates in the United States have recently dropped, they still offer favorable real returns to foreign investors. With an economic recovery in prospect here, the dollar is not likely to weaken greatly in 1983.

The strong dollar increases the price of our farm products to foreign customers. Over the past year, our farmers have received sharply lower prices, but after accounting for exchange rates, prices importers pay are rising. For example, even though the price of wheat was declining in domestic markets, the price to many foreign purchasers in terms of their currencies grew by 35 percent over the last two years. More importantly in a longer term sense, the dollar appreciation has accelerated the increase in our price floors in the eyes of our customers.

Our share of Soviet grain imports slipped from around 70 percent in the late 1970's to 17 percent following the U.S. embargo with the Soviet Union in 1980. It recovered to over 30 percent in the past year. The problem of reliability, coupled with continued East-West tensions, continues to cloud our trade prospects with the Soviet Union.

Our farm export markets also are being seriously undercut by unfair competition from the European Community (EC) and other nations. The EC has become the second largest exporter of farm products by spending upwards of $7 billion annually in subsidies. For example, in the Middle East the EC share of the whole chicken import market rose from only 3 percent in 1964 to 46 percent in 1980. During the same period, the U.S. share of the Middle East whole chicken import market declined from 97 percent to 13 percent.

Large Output and Rising Stocks Boost Global Supplies

Following two reduced grain harvests in 1979 and 1980, excellent weather in 1981 pushed world grain production to nearly 1.5 billion metric tons. Larger U.S. crops were an important factor in the global increase. In 1982, with widespread good weather, world grain production surpassed the 1.5 billion ton mark. U.S. grain output topped its 1981 record. Grain production increased in a number of importing countries, especially the Soviet Union and China. Weather also contributed to a sharp jump in world production of oilseeds in 1982, another large sugar crop, and large cotton crops in foreign countries. These weather-related developments will tend to have a negative effect on our trade during the next year.

With consumption of agricultural commodities depressed by deteriorating economic conditions for the last several years, rising production has caused stocks to accumulate sharply, particularly in the United States. We forecast that by the end of the 1982/83 marketing year, world grain stocks are likely to reach about 266 million tons, about 89 million tons higher than two years before. This would be equal to over two months' supply of grain for the world, the highest global stocks-to-use ratio in more than a decade. The measure of food security that these stocks would provide must be balanced against their lopsided distribution, since 155 million tons--or nearly 60 percent--will be located in the United States. These levels of carryover stocks are simply too large for the U.S. to hold. They depress prices no matter how tight free stocks become. We have seen sharp reductions in free stocks in recent years as the farmer-owned reserve was activated to strengthen markets. However, prices responded very little since domestic and foreign buyers, aware of the large stock overhang, were taking hand-to-mouth inventory positions and delaying purchases until new crop harvest-time pressures could offset any tightening in free stocks.

U.S. stocks of nearly all major commodities are expected to increase dramatically. By the end of the current 1982/83 crop year, compared with two years earlier, our ending stocks of rice and coarse grain will have more than tripled. Cotton stocks will be over three times larger than two years before. Wheat stocks will be half again as large, and U.S. soybean stocks will have risen by over one-fifth.

Clearly, the problems we face involve successive years of large production in the face of weak demand, resulting in the accumulation of huge stocks. Improved price and farm income prospects for future years will require that the necessary steps be taken as soon as possible to get supplies more nearly into balance with demand. It is essential that in taking action that we not fall victim to the temptation of simply legislating near-term prosperity through higher price supports or other rigid non-market actions that have been used in the past. Yielding to such temptation fails to recognize the realities of agriculture today and will only encourage farmers to produce more at a time when the market is strongly signaling the need for less.

Putting Agriculture Back on Course

Agriculture today is undergoing some difficult financial times--farm prices are too low; net farm income is too small; the farm debt is too heavy; and interest rates on existing debts are excessive. These problems constantly highlight the current agricultural news. The Farmers Home Administration is working closely with the American banking community, and with the Farm Credit System, to help farmers during this difficult period. Regardless of what has been said, there have not been massive foreclosures. In fact, during the 1982 lending season, only 844 foreclosures took place...that's 844 out of 270,000 borrowers at Farmers Home. That represents less than half a percent...hardly what you would call massive foreclosures.

Obviously, agriculture's problems are not going to be solved quickly. Indeed, I think it is very important to keep the recent actions taken by President Reagan and myself in the proper perspective. We are building a foundation upon which agriculture can expect to establish renewed prosperity and more stable economic conditions. This requires an understanding of the realities of the marketplace and the limitations of Government involvement.

Farmers' No. 1 market is the domestic commercial market. The condition of that market depends on the strength of the economy. Thus, the first priority of Government is to help build and maintain a vibrant, strong and expanding job-making economy.

We have made a good start in the last two years. The 1980 inflation rate of 13-1/2 percent has been cut to about 5 percent. The prime interest rate of 20 percent or more in 1980 has been cut to 11 percent--and every one-point drop in interest rates on the outstanding farm debt has the potential to raise farm income 10 percent. In December, the prices that farmers paid for all commodities--including services, interest, taxes, and wage rates--were 3.3 percent higher than a year ago, compared with a 12 percent increase in 1980.

In addition, President Reagan's recent State of the Union Address clearly indicates that this Administration is willing to work in a bipartisian manner to ensure that significant economic progress is made in the next two years.

Farmers' No. 2 market is the export market. While trade issues have and will continue to occupy a great deal of attention, it is important to remember that economic conditions are still the key factor in our export markets. Here again a strong U.S. economy is an important impetus to renewed economic growth abroad and a recovery in the export market for U.S. commodities.

At the same time, the rules of international trading are set by governments. So our Government has a responsibility to help American farmers capitalize on their efficiency by working to keep international agricultural markets competitive; to free up trade restrictions; and to counteract subsidized farm exports where American farmers must compete against foreign treasuries.

Where our Government is not successful in freeing up trade, or removing obstacles, or reducing foreign export subsidies, then we need to aggressively protect our markets. We favor using a greater share of our available public funds in aggressive programs to expand exports. On January 11, the President announced a $1.2 billion "blended-credit" program--interest free direct export credits blended with Government-guaranteed private credit--to expand agricultural exports through lower interest rates on those exports. This is in addition to the three-year $1.5 billion authorized in late 1982.

More recently, we completed negotiation of a one million metric ton U.S. wheat-flour sale arrangement with Egypt. This is a major thrust in our attempt to aggressively compete for the Egyptian flour market--the largest in the world. The U.S. Department of Agriculture will provide, on a competitive bid basis, enough wheat from Commodity Credit Corporation stocks to enable U.S. suppliers to contract for sale and delivery to the Egyptian market at the negotiated price.

All of the problems of U.S. agriculture are not rooted in basic trade issues; and the resolution of such issues will not ensure a return to prosperity for our nation's farmers. But we don't think the American public wants the Government to sit by while our farm exports suffer. Every American has a stake in our farm exports, since those exports create a favorable balance of agriculture trade that compensates for our deficits in industrial trade. Our strong favorable balance in agricultural trade benefits every American who uses petroleum or imported consumer goods. Every $1 billion of agricultural trade creates an additional $1 billion of U.S. economic activity; that means jobs--35,000 jobs for each additional $1 billion in exports. The wheat-flour sale will generate $850 million in additional economic activity and create jobs for over 9,000 people.

President Reagan, in recently signing the Commodity Futures Trading Commission Reauthorization Act, once again reaffirmed his strong policy of supporting farm exports. Our reputation as reliable suppliers in world markets has been tarnished only by past administrations, not by farmers and their ability to produce and be competitive. Provisions in the Act firmly establish the sanctity of contracts that many of our foreign buyers had been concerned about in the past. When our foreign customers' ability to buy has been restored by improved economic conditions, the fruits of the President's action will be harvested by our nation's farmers in the form of increased exports.

Until the demand for U.S. products recovers, it is clear that a production adjustment must be made. On Janury 11, President Reagan announced a Payment-In-Kind (PIK) Program for 1983 crops of wheat, corn, grain sorghum, rice and upland cotton. The basic concept of the PIK program is that farmers are offered an amount of commodity as payment-in-kind for reducing acreage, over and above the requirements of the acreage reduction and cash land diversion programs already announced for 1983 crops. Indications are that producers are finding the program attractive and significant acreages will be removed from 1983 production. We don't expect to completely liquidate burdensome stocks in 1983/84, but we do see this program as a major step in bringing crop supplies into line with demand.

The PIK program has several appealing and unique features:

- Production can be reduced beyond that expected under the 1983 programs for wheat, corn, grain sorghum, rice, and upland cotton, and thus bring supply back into closer balance with demand.
- Stocks can be reduced at the same time that production is cut back, lessening the overhang on the market at harvest next year and enhancing the prospects for a market-led recovery in farm prices and incomes in future years.
- The availability of market supplies will be maintained, signaling to exporters and importers that the United States fully intends to remain a realiable and consistent supplier when production adjustments are made. To meet our long-term export and food aid commitments, adequate reserves will be maintained.
- Government outlays for domestic programs (e.g., loan volume, storage payments, deficiency payments) should decline.
- The PIK program, unlike other emergency measures, is self-terminating when excessive stocks have been worked off.
- Farmers will have the same or greater net returns while stocks are being reduced.
- Sound conservation practices will be applied to a larger amount of acreage.
- Storage space problems will be lessened.

This massive land diversion program, the expanded blended-credit program, contract sanctity and Government arranged export sales must be kept in focus. They are all building blocks to ensure that agriculture is in a position to share in the rewards that will come with renewed economic growth in the U.S. and the rest of the world. We may have to take some dramatic and innovative approaches to our current problems, but there should be no doubt in anyone's mind that a strong, market-oriented agriculture with minimum Government intervention is the ultimate solution.

We still have some difficult times ahead but I am more optimistic than ever that we have programs in place which are going to permit our farmers to emerge from these difficult years in a strong, competitive position that will ensure a more lasting prosperity. However, we must be careful that in our desire to restore prosperity we recognize agriculture's interdependencies.

Recognizing the Realities Concerning Agriculture

The evolution of the economic conditions in the agricultural sector over the past decade has significantly altered the interdependencies of the sector. At the same time, it has reduced the effectiveness of many of our traditional commodity programs.

Agriculture is an integral part of the U.S. economy. It is vital domestically and to the international interest of the United States. Broadly defined, agriculture is the nation's largest industry with assets equal to about 88 percent of all manufacturing corporations. Agriculture also is the nation's largest employer. The value added to farm products as they flow through the economic system amounts to 20 percent of the Gross National product and requires the services of more than 23 million people, or about 22 percent of the labor force.

At the same time, it is a major force in world trade and makes a significant contribution to the U.S. trade balance. The U.S. accounts for 40 percent of world trade in wheat, 58 percent of the trade in coarse grains and 84 percent of the soybean trade. We now export the production from 2 out of every 5 acres we plant.

This expanded role in U.S. and world economies has brought a growing interdependency which we are now only beginning to appreciate. I think factors such as floating exchange rates, the declining value of the dollar, the inflationary spiral of the seventies, and excessive amounts of credit following the major crop shortfalls of the early 1970's may have let us see only the positive side of this growing interdependency.

Now agricultural supplies are relatively abundant, the dollar has increased relative to other currencies, and world economic growth has become stagnate. We are now seeing the other side of the coin and we are discovering that the traditional measures we have used in the past to rejuvenate the agricultural sector have had limited success. The agricultural economic system no longer has geographic borders that permit action and reaction in a vacuum. It is a dynamic system in which rigidity leads to imbalances. Actions taken in any sector of our economy or the economies of any of the major countries in the world now impact agriculture immediately. These are the realities that we all are beginning to understand more fully.

Examples of my concern over the implications of these realities for farm programs are readily available. The artificial umbrella over world prices that we have created through the persistent upward ratcheting of our domestic support prices during the past inflationary spiral has served to encourage producers in other countries to increase production. This surplus production is then subsidized into the world markets. As long as the total market was expanding and the dollar was declining in value, this did not seem important. Now markets are not growing or are shrinking for a variety of reasons and we are finding it more difficult to keep our agricultural base fully employed. To make sure this does not become a serious issue, producers in this country, as well as around the world, need to receive and respond to market signals to avoid constant swings between surpluses and shortages.

The 1981 Farm Act mandates that the target prices for wheat, feed grains, rice, and cotton be increased each year over the life of the bill. While these increases may have seemed fairly reasonable in the context of the rapid inflation of 1980-81, we have seen dramatic improvement in reducing the rate of inflation. The mandated increases in the target prices now provide incentive for production increases at a time when moderation is needed. Production costs only went up 3 percent in 1982, and many input prices are now actually lower than a year ago. We must make sure that after stocks are reduced significantly, we do not have price supports and target prices that would get us back into the same situation we are in today. This is the reason we are seeking authority for the Secretary of Agriculture to maintain current target prices. We must take every precaution to keep the grains sector from falling into the same situation that dairy is in now.

Dairy is an example of losing touch with our domestic markets through rigid price support levels not sensitive to market conditions. For the last several years, dairy farmers have been responding to rising milk support prices rather than to actual demand levels. The program now costs over $2 billion per year. They have increased the dairy herd and production per cow in the face of excessive supplies. Now, under pressure to reduce milk output, they have three hard choices: cutting back production, switching to other enterprises, or finding work off the farm. No one likes these choices, but there are no alternatives.

Our farmers want the opportunities that the marketplace can offer, both domestically and internationally. They are willing to take the risks that are inherent in the market if it is free and fair. We must be certain the Government actions don't distort the signals the market is sending, while at the same time, providing support when the need arises. We are taking some actions now to get agriculture back on course but we don't want to follow the same path that has led us to our current situation. This is the challenge that faces use over the next few years. With your help, in addition to others, we can get the job done.

Today's Farm Problem...

LARGE SUPPLIES

PLUS

WEAK DEMAND

EQUAL

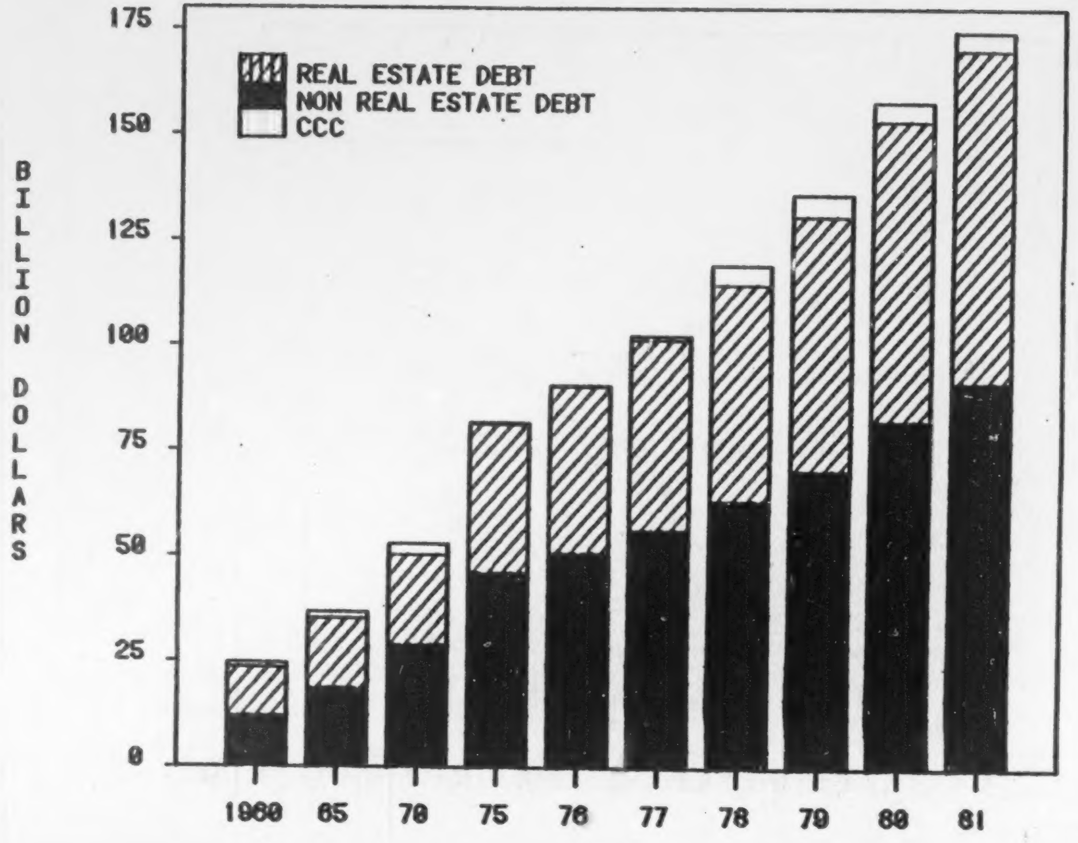
LOW PRICES

WHY ARE
CROP SUPPLIES
SO LARGE

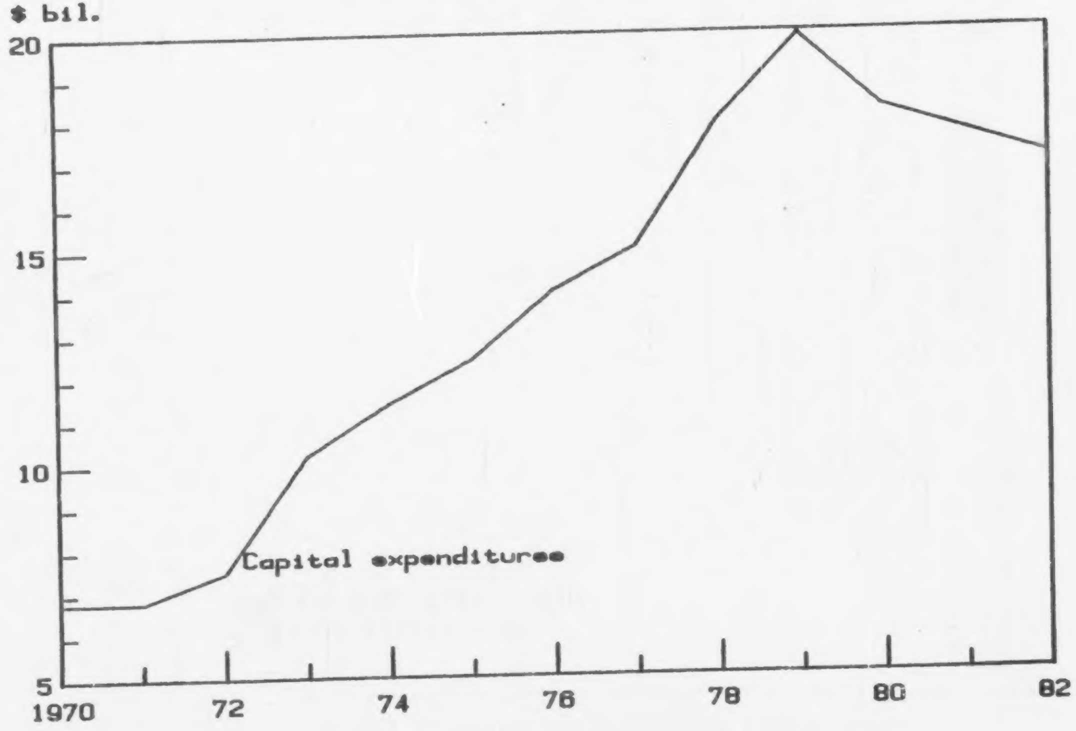
MANY FACTORS PROPELLED PRODUCTION UPWARD OVER THE PAST DECADE:

- Easy Credit
- Heavy Capital Investment
- Rising Prices, and Price Supports
- Booming Farm Exports
- Acreage Expansion
- Yield-Boosting Technology
- Excellent Weather in 1981 and 1982
  --in U.S. and Other Key Areas

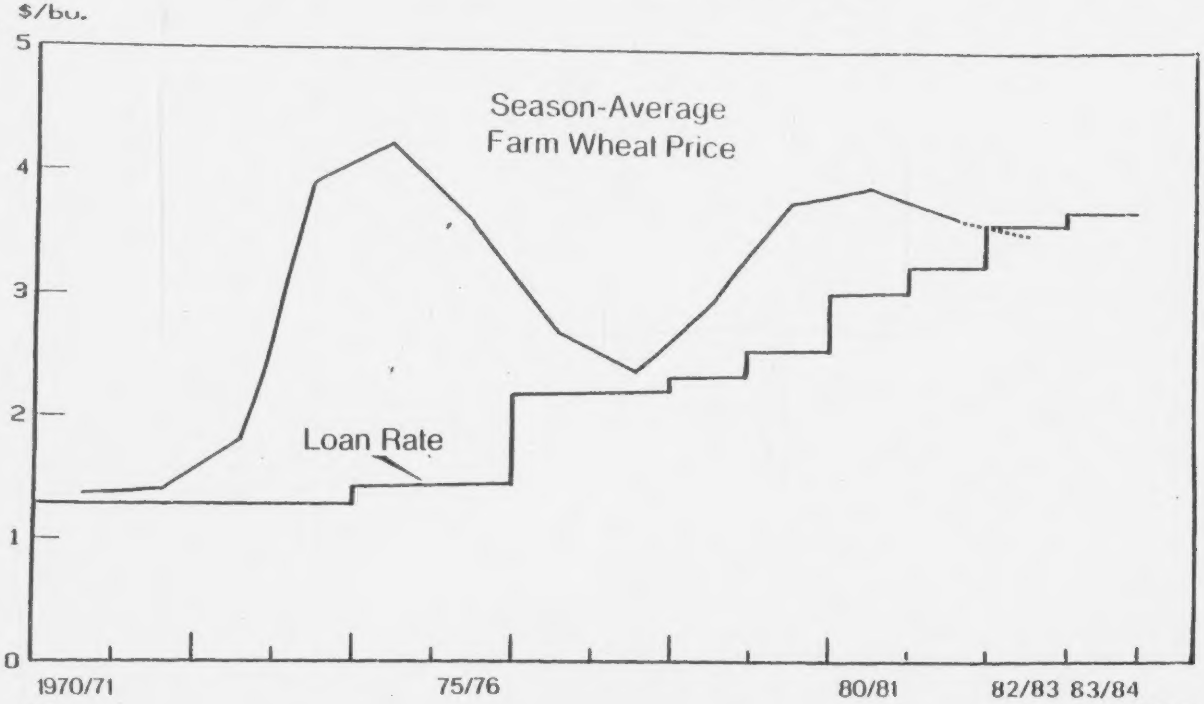
Easy Credit Has Boosted Farm Debt



Capital Investment Was Heavy During 70's



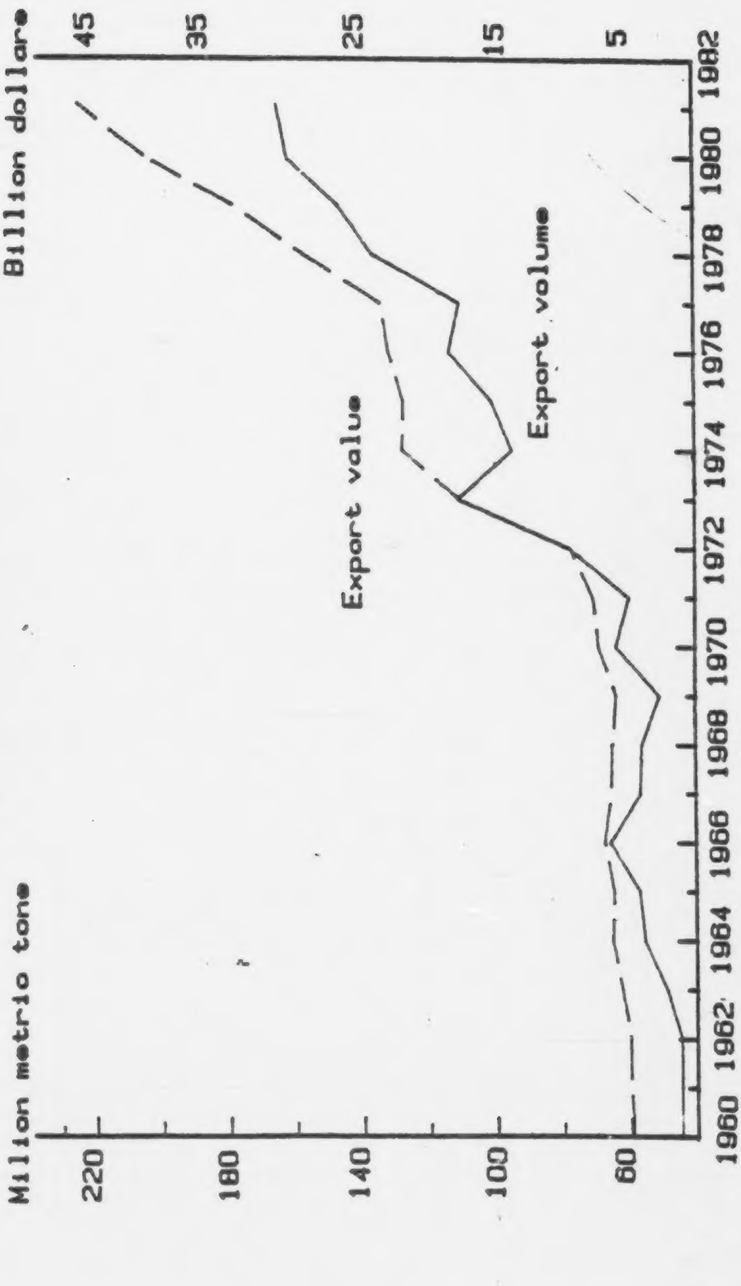
Prices and Loan Rates Trended Upward

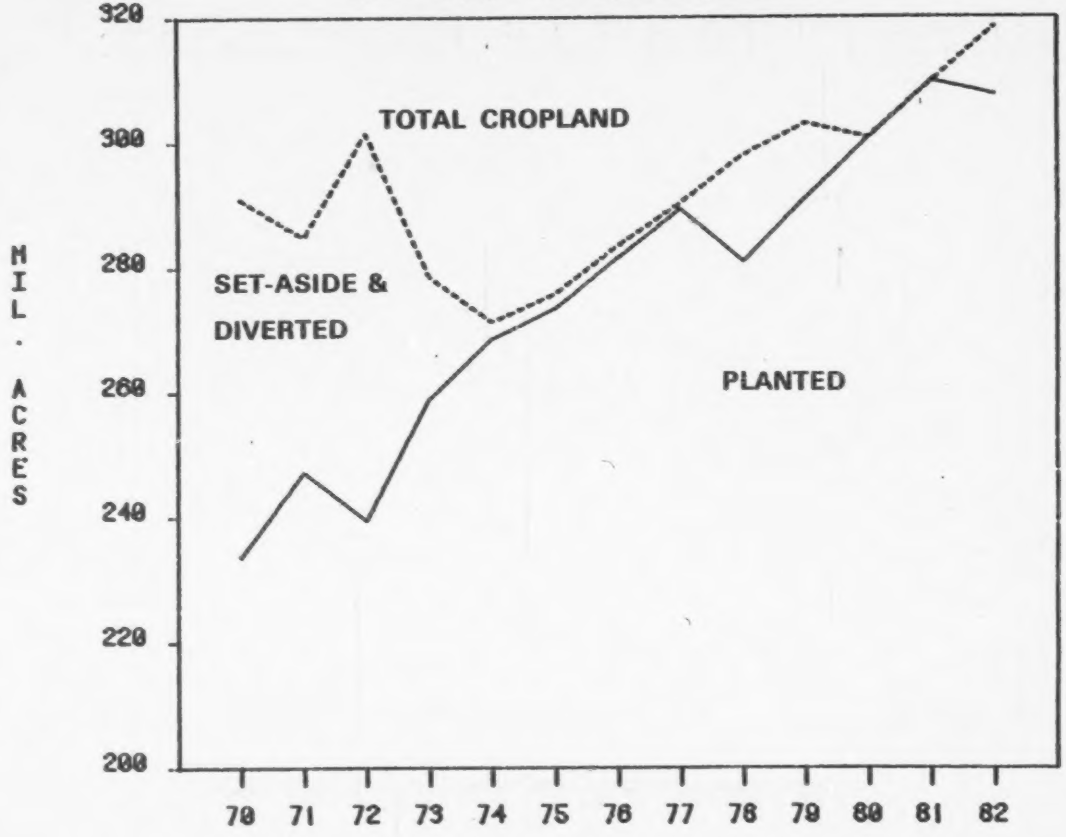


USDA

DECEMBER 1982

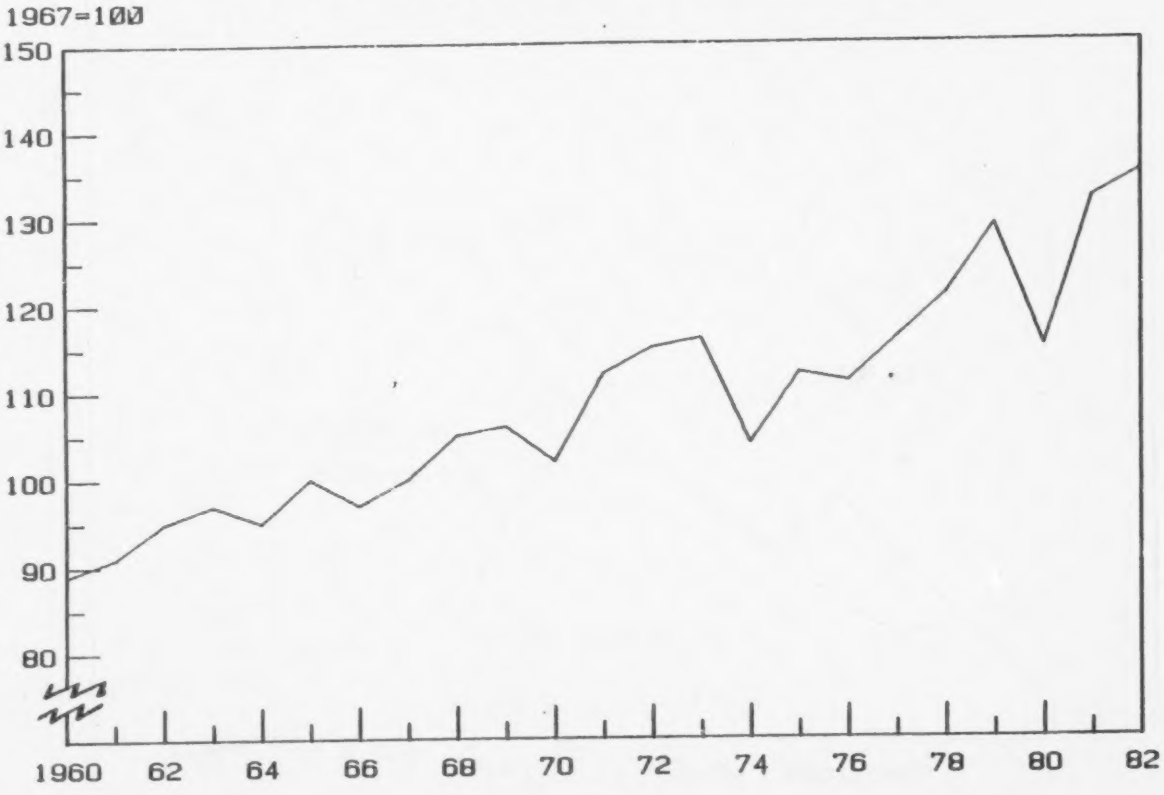
Agricultural Exports Soared



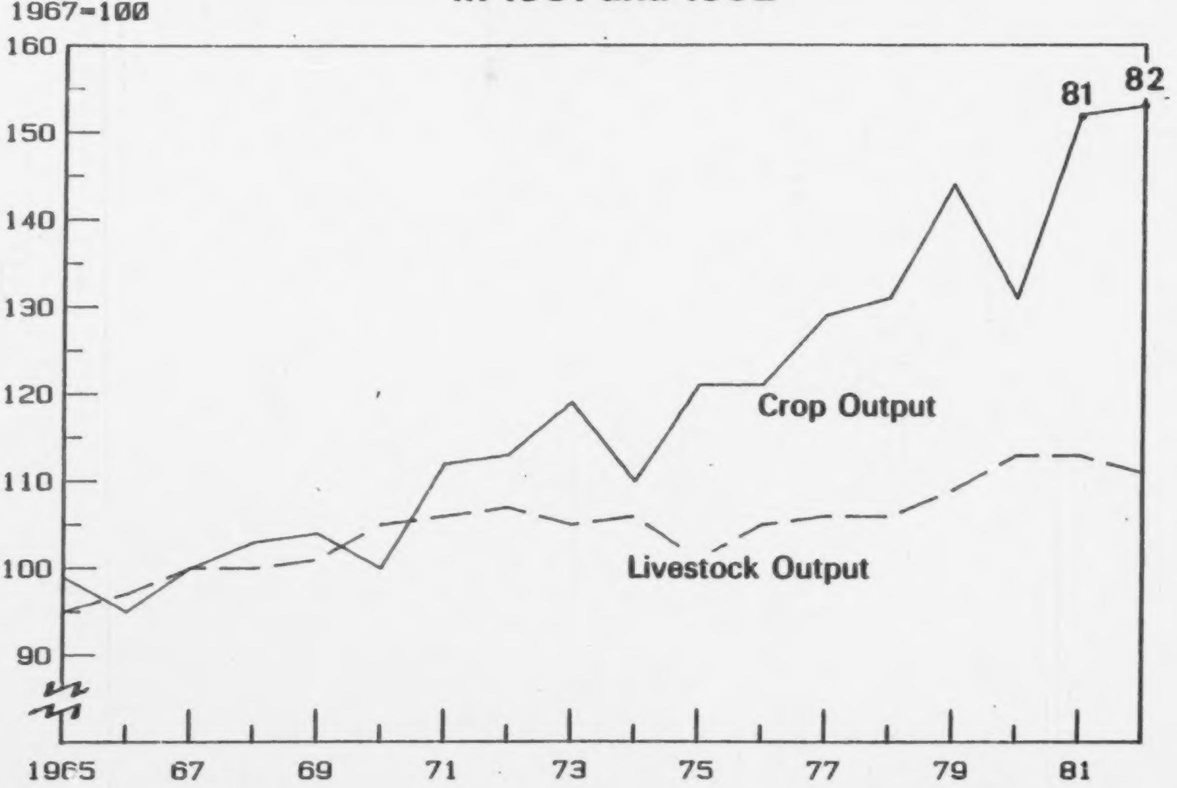


U.S. Crop Acreage Expanded

Technology Boosted Yield Per Acre



Weather Pushed Crop Output to New Peaks in 1981 and 1982

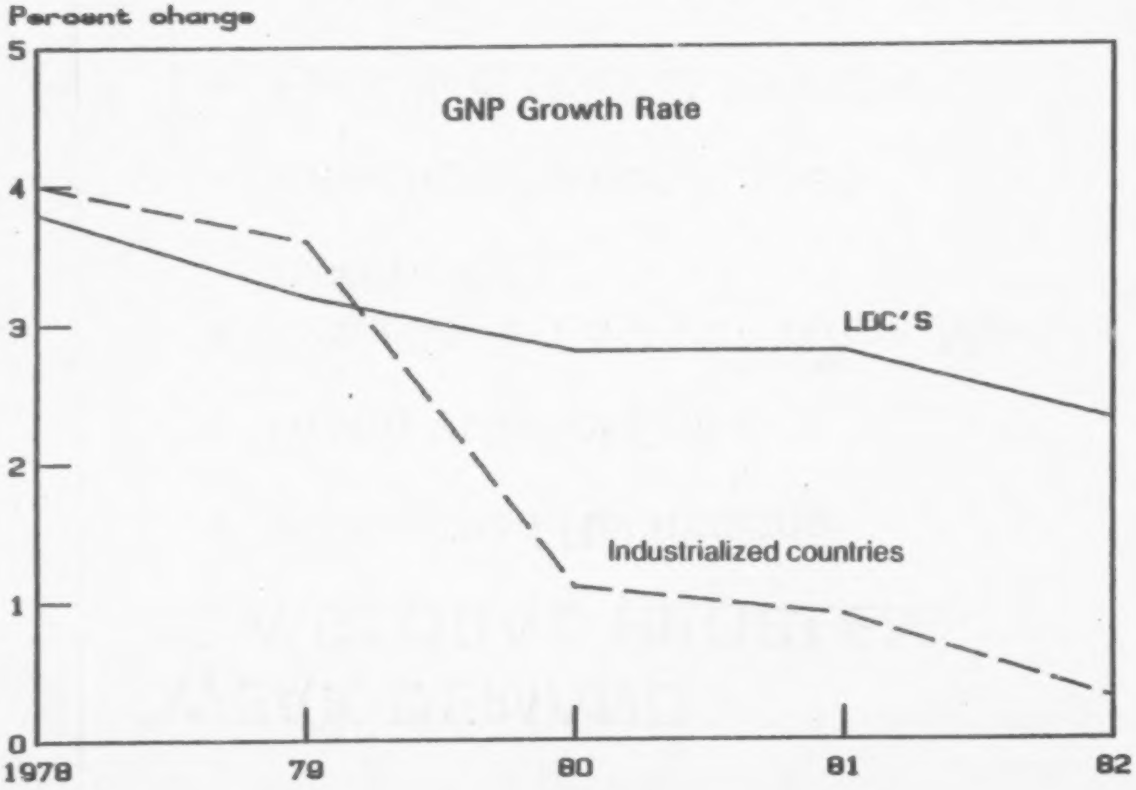


WHY IS
DEMAND
SO WEAK

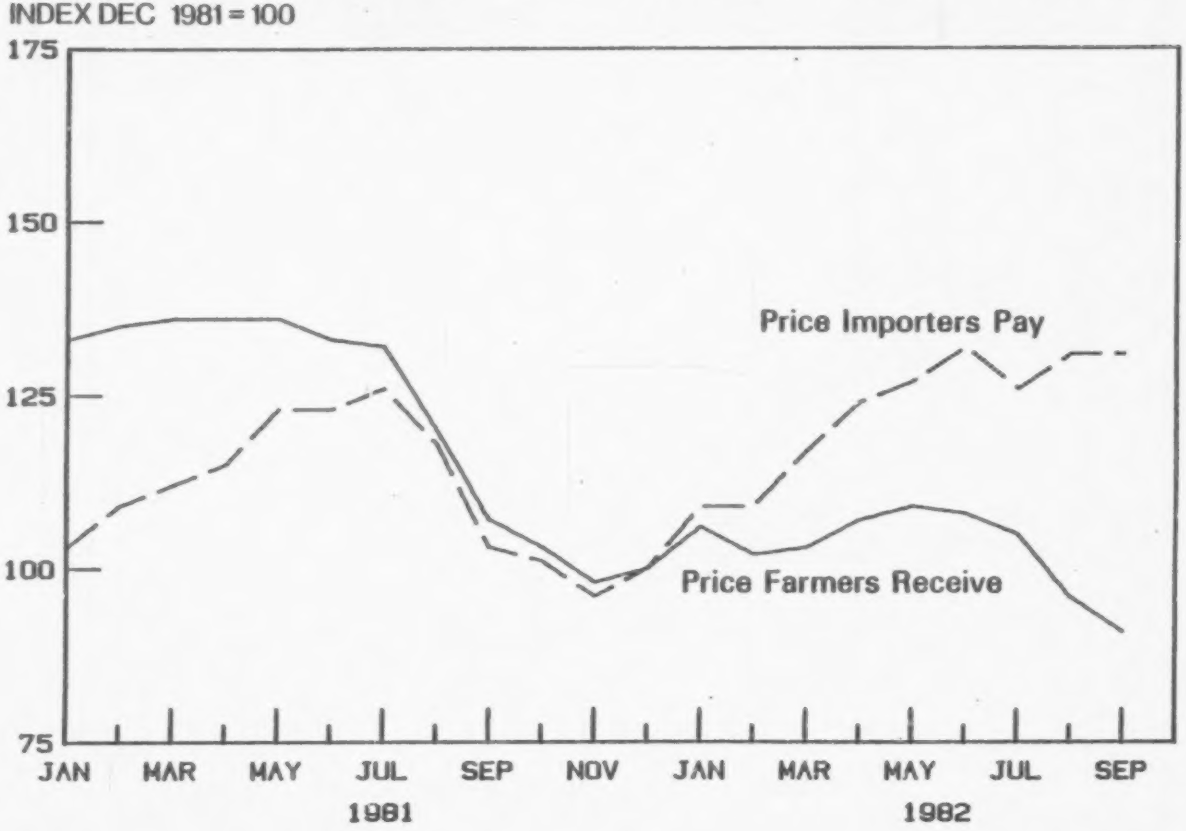
WEAK DEMAND
IS A GLOBAL PROBLEM

- Widespread Recessions
- Rising Value of Dollar
- Instability in Eastern Europe, Mexico, elsewhere
- Embargo-Related Losses
- East-West Political Tensions
- Unfair Trade Practices

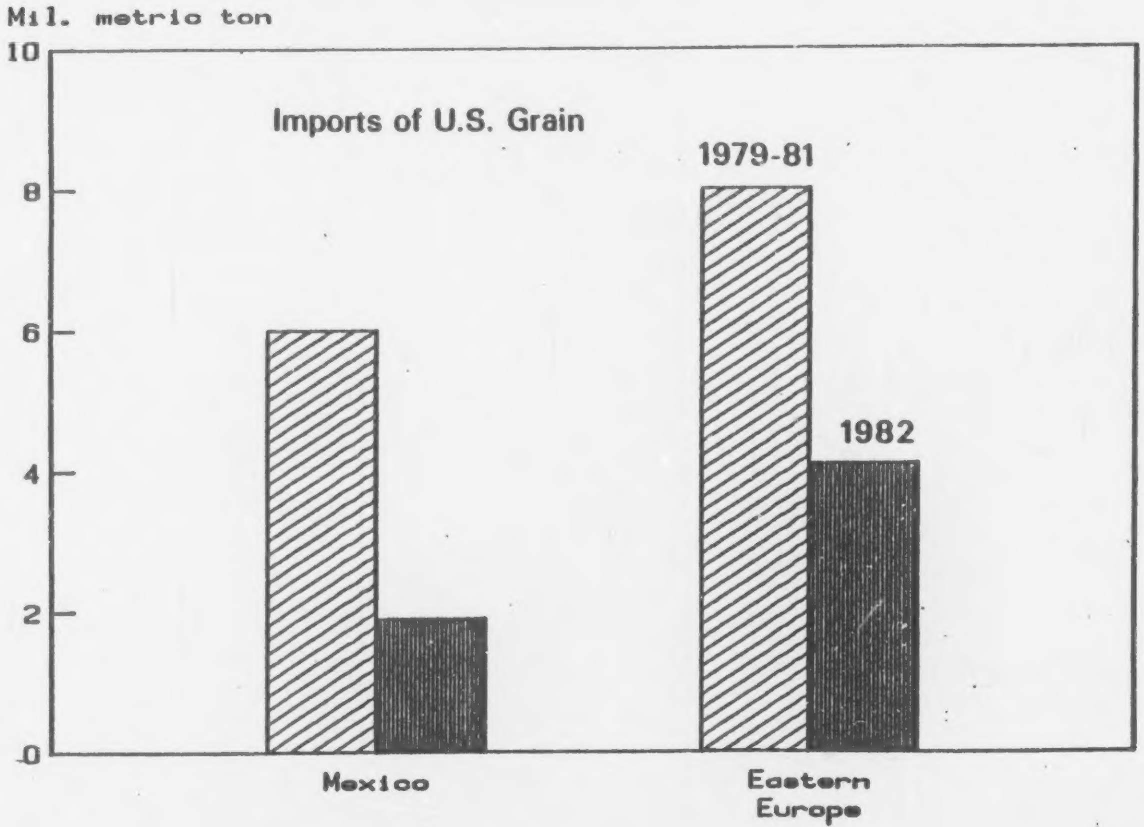
Widespread Recessions



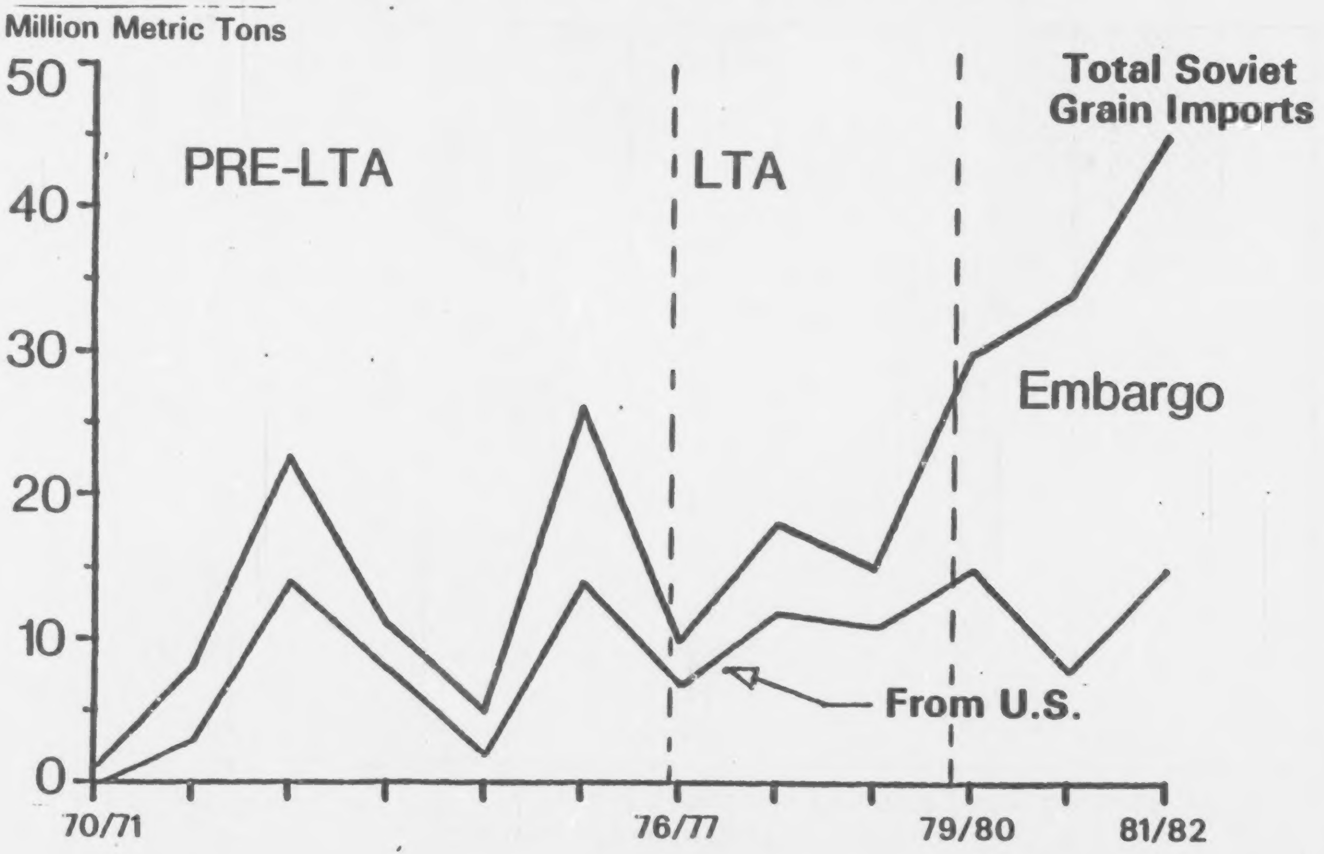
Rising Dollar Makes U.S. Corn Exports Less Attractive



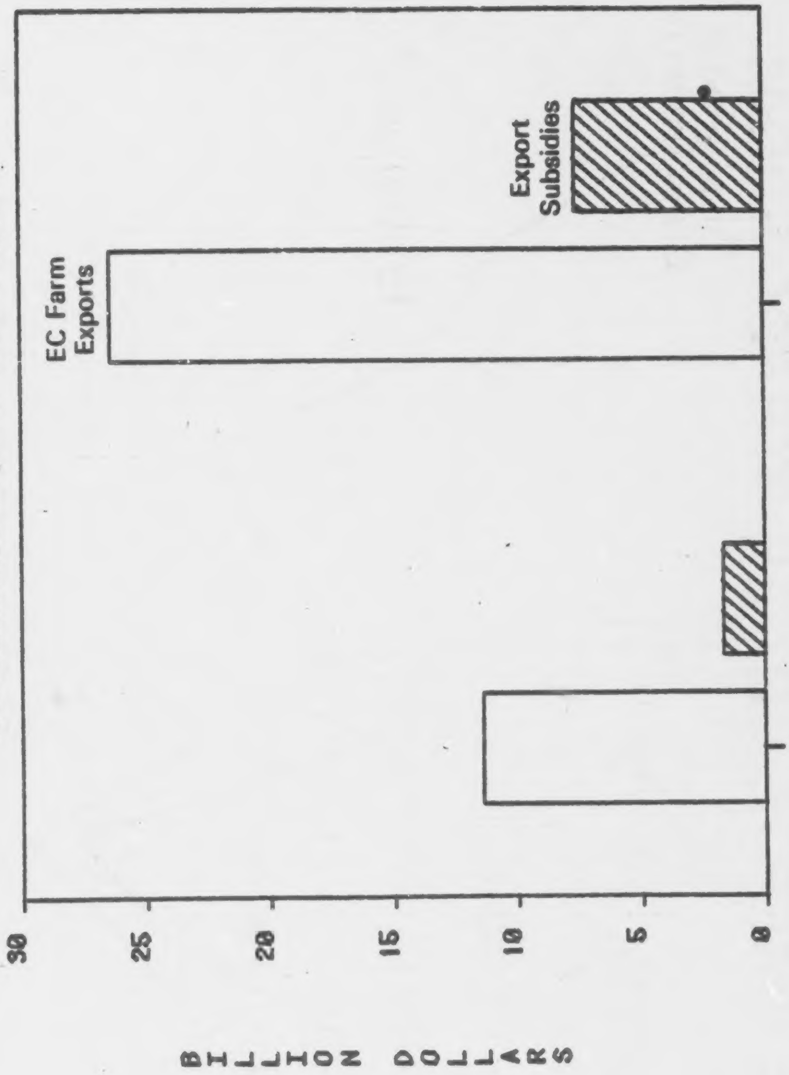
Instability Reduces Farm Exports



Embargo Cut U.S. Share of Soviet Grain Imports



EC Subsidies Expand Their Exports

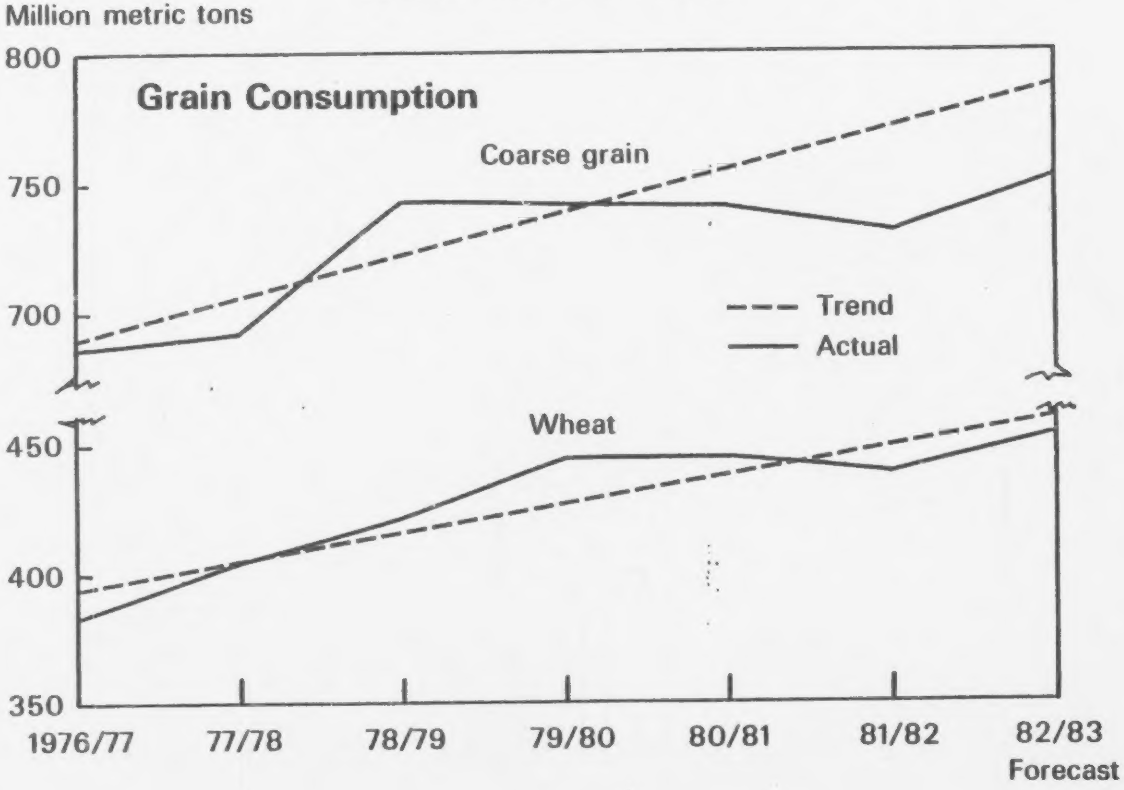


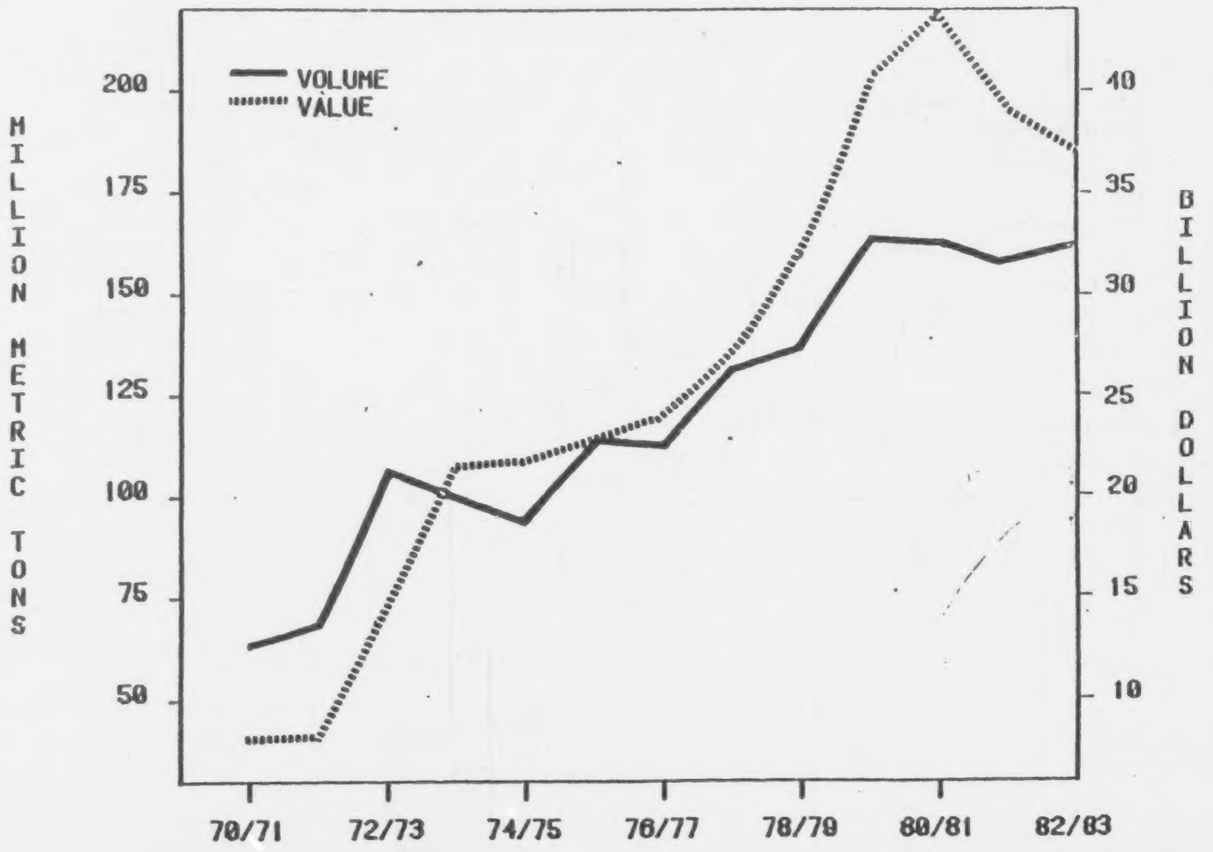
THE FARMER IS UNDER STRESS FROM:

- Weak World Demand
- Reduced Exports
- Soaring Stocks
- Depressed Farm Prices
- 3 Years of Poor Farm Income
- Drop in Farmland Prices
- Costly Credit
- Solvency Problems

GOVERNMENT OUTLAYS SKYROCKETING

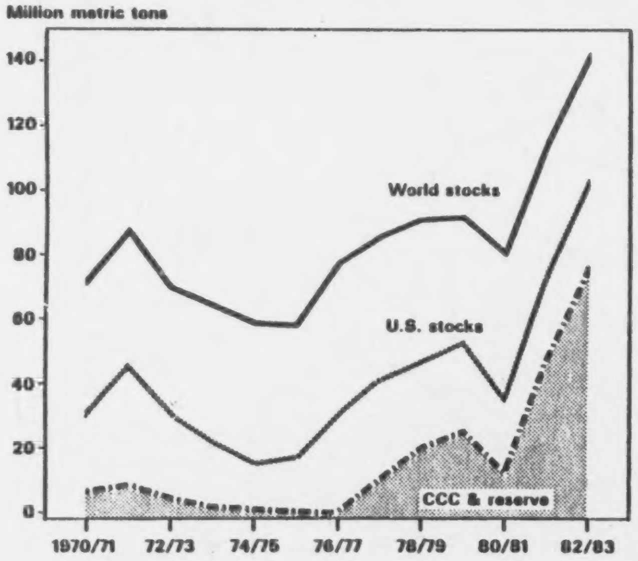
Weak World Demand



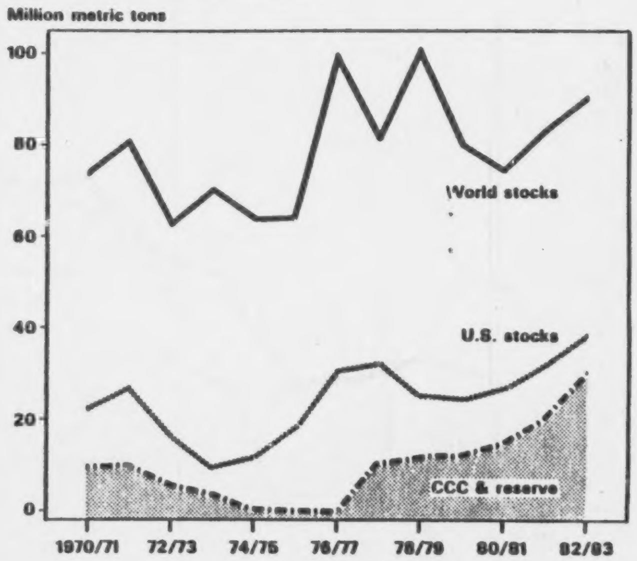


Farm Exports Have Dropped

Soaring Grain Stocks



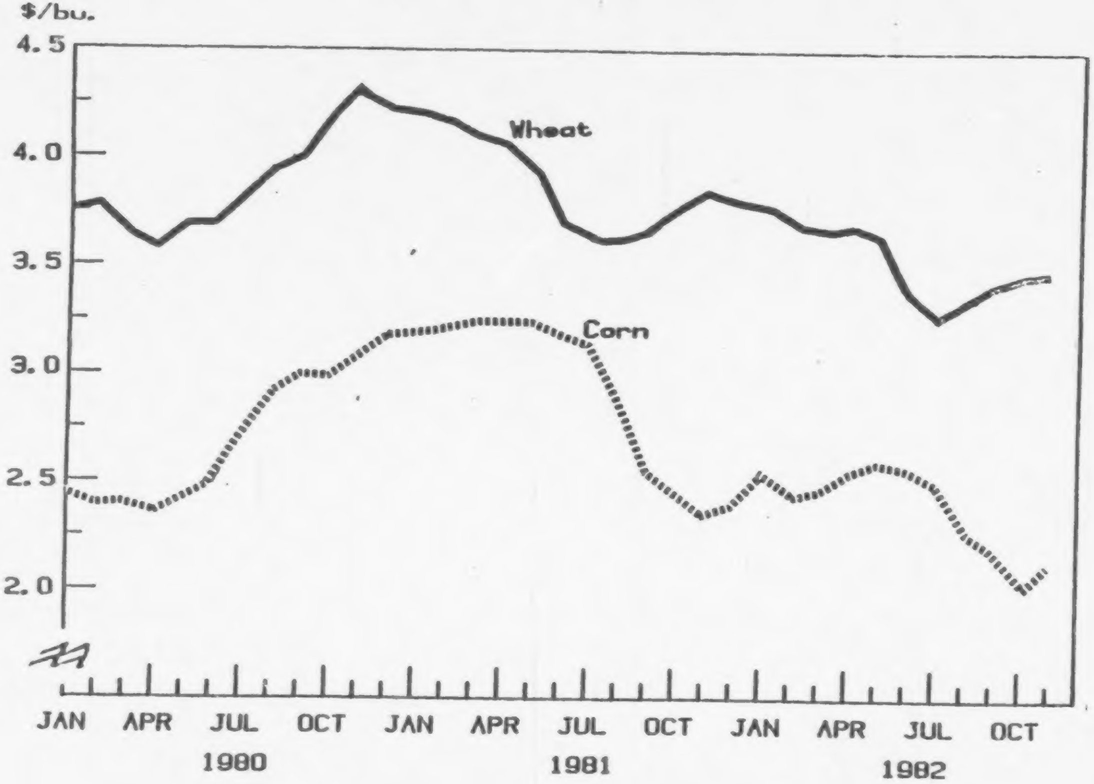
World Coarse Grain Ending Stocks



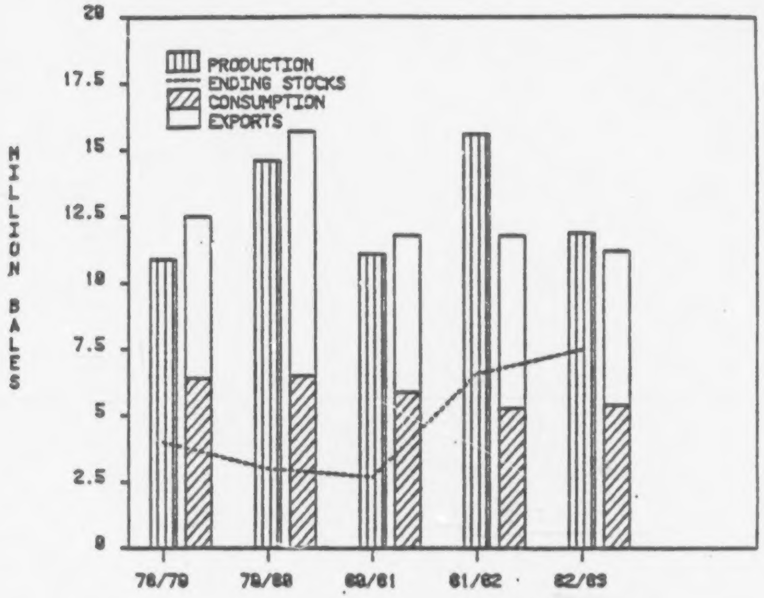
World Wheat Ending Stocks

October 22, 1982

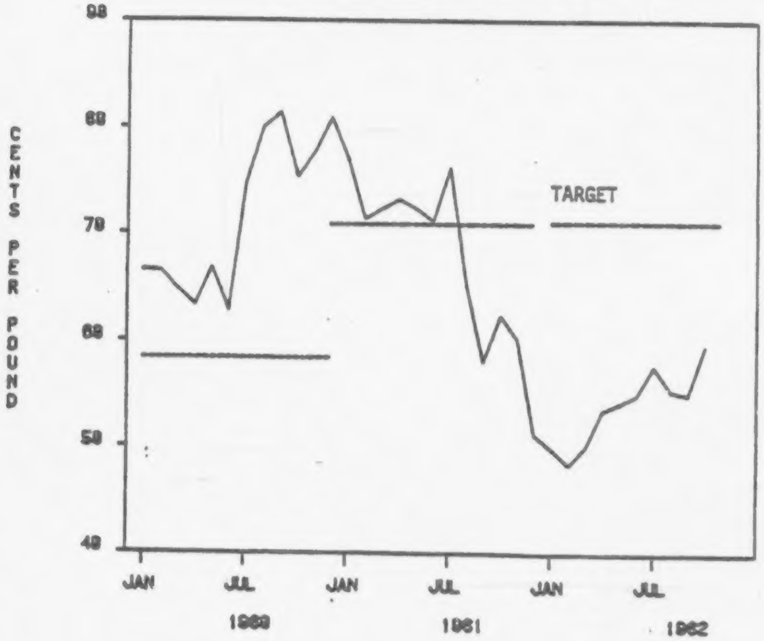
Grain Prices Are Depressed



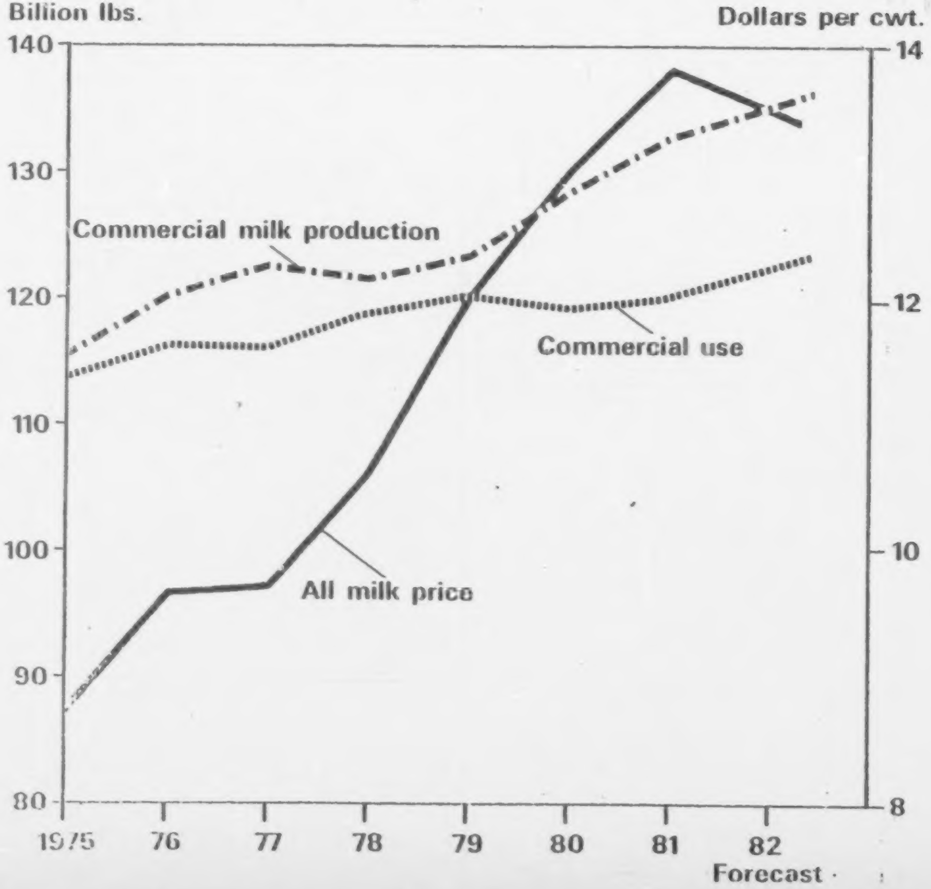
Large Cotton Supplies, Depressed Prices



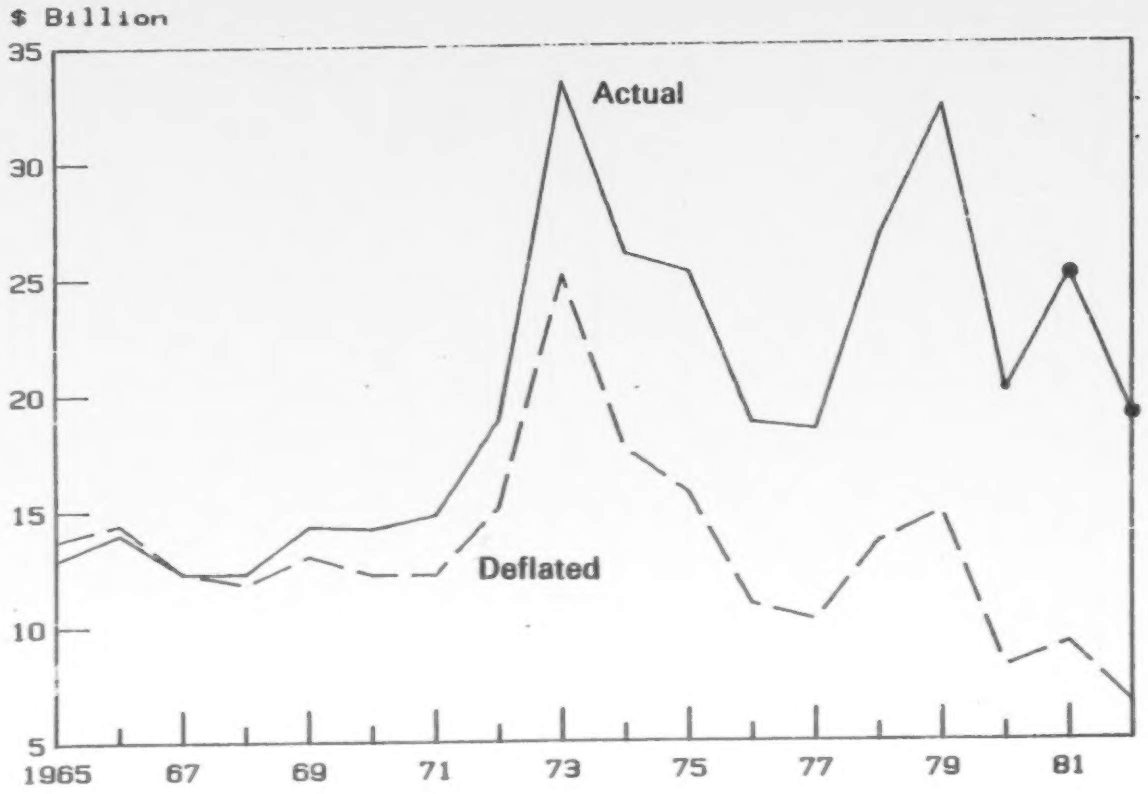
PRICES RECEIVED FOR UPLAND COTTON

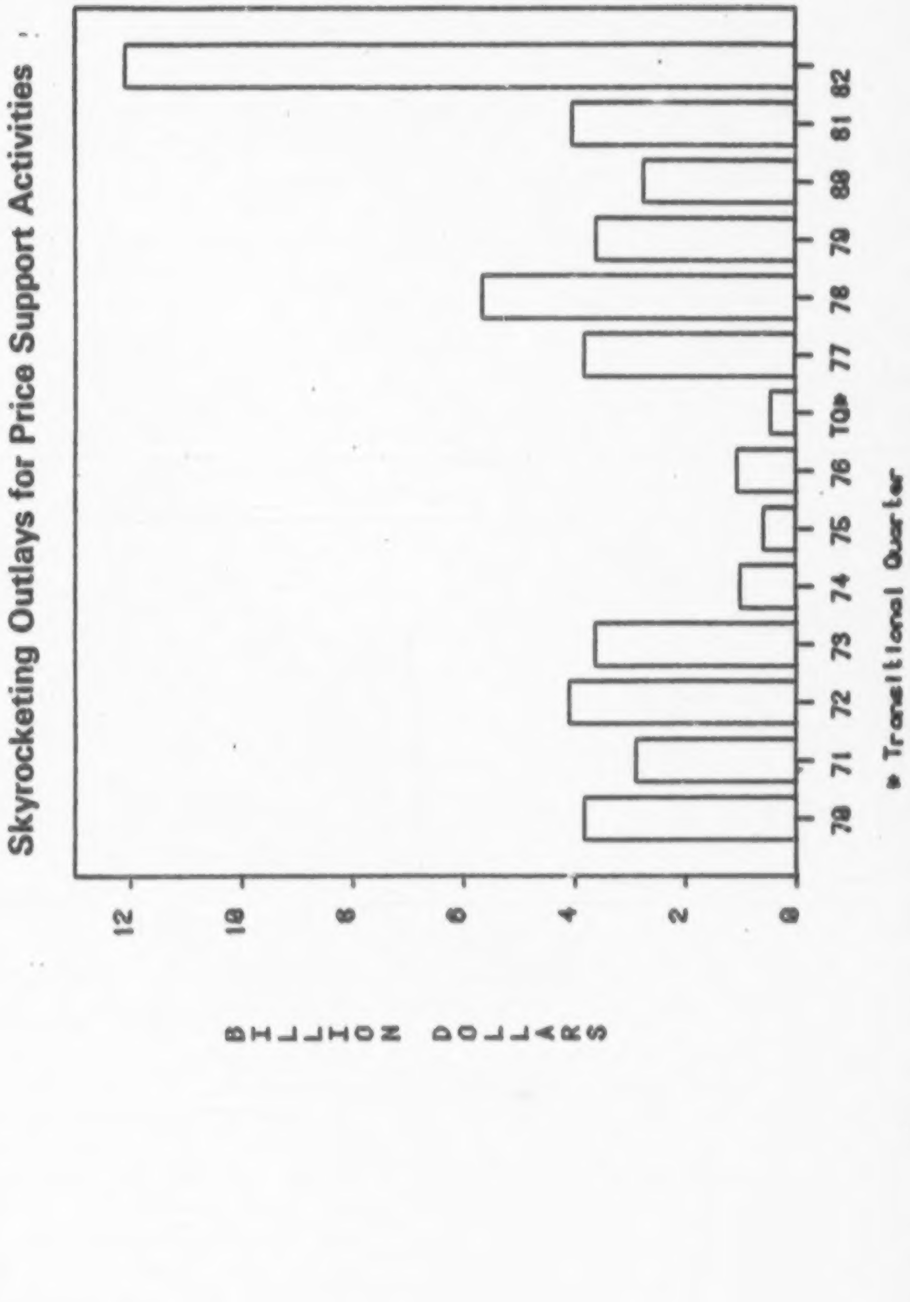


Milk Production, Use and Price



3 Years of Poor Farm Income




Skyrocketing Outlays for Price Support Activities
BILLION DOLLARS
12
10
8
6
4
2
0
70
71
72
73
74
75
76
TQ*
77
78
79
80
81
82
* Transitional Quarter

Senator JEPSEN. Thank you, Mr. Secretary, for that very comprehensive report and, as was evidenced by your occasional trips away from your prepared text, your understanding of agriculture is one that is both comprehensive, and realistic, and it's based on what the real world of agriculture is all about. I'm pleased that we're working together to try to solve these problems. You can be assured of the continued cooperation of those of us from the States, especially the States that produce all this wonderful food and these products that we have from this renewable resource in this great land. We'll do all that we can to continue to work with and help educate our city cousins to support us.

Let's get to the issue at hand. People are talking about the problems associated with the PIK program, Mr. Secretary. I have received reports that the Internal Revenue Service will treat grain received under this payment-in-kind program as cash income at the time of receipt. That is, that's the rumor that's running rather rampant in agricultural circles around the country. In other words, farmers are going to have to pay taxes on the grain in 1983.

Now, as anyone who understands anything about farming at all knows, farmers do not operate that way. Taxes are not due at the harvest time. Taxes are due when farmers sell their crops and receive their cash and then they pay their taxes.

Have you contacted the IRS about this and what is your feeling? We visited briefly before we started this meeting today and discussed how to get the job done and to see the results of the PIK program which is designed to alleviate these depressed prices by consuming and eliminating these huge surplus reserves of grain.

To a significant extent, this job will get done through cattle, hogs and other livestock feeders. If these feeders suddenly are presented with a sort of left roundhouse hook because the IRS does not understand the feeding methods of livestock producers, the effectiveness of this PIK program, in my opinion, is possibly going to be in danger.

It's so serious that I'd like to air it here and I would hope that the IRS is listening in.

Secretary BLOCK. Mr. Chairman, our attorneys have been in contact with the IRS since the first of the year, trying to get a ruling on this. You're right. It's only practical and reasonable that if you receive this commodity you don't pay taxes on it until you sell it, or if it's fed to livestock until you sell that livestock. You just can't have the situation where the day grain comes under your possession that you are charged with that tax obligation.

I would hope that we would get that kind of ruling. We don't have a ruling from them yet. They may not have enough latitude under current law to give a favorable ruling. If we did not get a favorable ruling, then I would hope that the Congress could help us out.

In addition, there may be a possibility of writing the contract in such a way so that if the producer elected to sell his PIK commodity after the first of the year he could insure that he would not have to pay taxes on the commodities prematurely.

This would be a last resort and more complicated than necessary. But I would assure the potential participants in this program that I will be safeguarding their interests with a practical approach to this problem. I appreciate your interest in it also.

Senator JEPSEN. The PIK program is now in the signing-up process and the last date for signup has been given as the 11th of March; time's awasting. Do you have any indication as to how much longer the IRS may take? Some of us may enter into this if you so desire and see if we could encourage an early decision by the IRS. Isn't it necessary that they do this quickly?

Secretary BLOCK. Well, I think it's necessary that we clear up this question one way or another, either through a favorable ruling, legislative action, or action on our part to change the contracts.

I think it is something that is manageable. It will be taken care of in the end. I'm convinced of that.

Mr. LESHER. We're not sure, though, that a resolution can be accomplished by March 11. That is crucial.

Secretary BLOCK. We don't know.

Mr. LESHER. I think it would be fair to say that this issue is of great importance and getting a final resolution of this issue before March 11 is imperative. We are not at this time confident that all tax issues can be resolved with the IRS ruling. They may not have the latitude under current law.

Senator JEPSEN. Well, I'm sorry to hear that. You know, in the real world, farmers don't have the luxury of all those folks out there. There's a time to plant and there's a time to plan and there's a time to harvest and there's a time to till. In the real world they don't have time for 18 months of committee meetings of passing the buck around and especially making something very complicated that isn't complicated at all. If they'd just, you know, don't fix it if it isn't broken—if they could go along with that instead of all this bureaucratic nonsense they have of piling additional layers of redtape and paperwork so they can try to hire some more people—just simply let the people out there that are working and obeying the laws and paying the taxes and making things happen in this country do it. And the IRS had better doggoned well get that ruling issued and issued very, very soon. I expect that we'll get on this with other committees, including this one, before the day is over.

Now one last question, Mr. Secretary. In your prepared statement you touched on the figures regarding foreclosures and you indicated this was one-half of 1 percent, and I appreciate that, but how do these 1982 figures compare with the past, and also, what areas of the country are these foreclosures coming from? I mean, is this one-half a percent more or less than last year?

Secretary BLOCK. I don't have the details on that, Mr. Chairman. I will make them available to the committee.[1] I suppose that compared to a lot of other businesses, it's still quite small. That doesn't mean we're making money out here. It just means that people are hanging in there even during tough times.

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[1] See response, p. 164.

Senator JEPSEN. Well, I know that there have been repeated accusations and every time that we have received one and have inquired we find that in fact usually the opposite has been true; rather than somebody having been foreclosed without having a hearing and so on, we find that the Farmers Home people have been working and have had a number of meetings with them and many times are still doing the best they can.

In the state of the Union message the President stated that USDA will be working on a one-to-one basis with financially troubled farmers and really we find that's what you've been doing. Is this a new, expanded USDA service or has this been par for the course for you?

Secretary BLOCK. This is what we have been doing and the President said that in his speech in which he gave reassurances to producers in the United States that we are sensitive to their needs and problems. We're going to do just precisely what the President said we would do.

Senator JEPSEN. Would you say, then, that reports of the Farmers Home Administration as being totally insensitive and even, according to some articles I've read, where Farmers Home has been portrayed like they are going out looking for someone to foreclose on, as accurate?

Secretary BLOCK. There is not a particle of truth in that. Actually, as I pointed out, the number of foreclosures is small. Furthermore, the whole farm credit system—the PCA's, the Farmers Home Administration, commercial banks—collectively, have received a bum rap because there's been a major effort to work together and help producers who have a good chance of surviving. You rarely get any articles complimenting everyone that's working so hard trying to salvage producers and keep them in business. I guess they tend to point out the few that are going out of business and if you research some of those that have been highlighted on television, you'll find out they haven't made a payment in 3 years. It's not that all of a sudden they've gotten in trouble and somebody is trying to liquidate them. I repeat again, some of them haven't made payments of any kind on the land in 3 years. Now what do you do about that? You don't just say, well, that's all right and go on, because if you say something like that and make that kind of determination you destroy the integrity of agriculture as an industry that would lead to less money being lent to farmers.

Senator JEPSEN. I would appreciate Mr. Secretary, that you provide for the record how the 1982 foreclosure figures compare with the past and what areas of the country these foreclosures are coming from.

Mr. LESHER. The point I think you're driving at I think is correct and we would be happy to get you these figures. In general the percentage of foreclosures—and we've looked at the Farmers Home, the farm credit system, and the commercial banks that service agriculture—is not up very much at all from prior years. I think this is the point you're trying to make, and it is the correct one, and we can provide the figures. I just wanted to make the point that it is not a huge number:

[The following information was subsequently supplied for the record:]

A precise tabulation of the number of foreclosures initiated by FmHA was not maintained by previous administrations, and there is no record for comparison with the tabulation started by the agency as of October 1981. The following table shows how many such foreclosures were completed in each State, Commonwealth, or territory during fiscal year 1982:

Alabama	29
Alaska	0
Arizona	1
Arkansas	33
California	3
Colorado	12
Connecticut	0
Delaware	0
Florida	15
Georgia	17
Hawaii	0
Idaho	44
Illinois	9
Indiana	52
Iowa	1
Kansas	7
Kentucky	10
Louisiana	4
Maine	21
Maryland	5
Massachusetts	0
Michigan	6
Minnesota	8
Mississippi	109
Missouri	69
Montana	2
Nebraska	14
Nevada	0
New Hampshire	1
New Jersey	0
New Mexico	1
New York	5
North Carolina	51
North Dakota	5
Ohio	7
Oklahoma	17
Oregon	4
Pennsylvania	18
Puerto Rico	0
Rhode Island	0
South Carolina	48
South Dakota	8
Tennessee	25
Texas	36
Utah	1
Vermont	0
Virgin Islands	0
Virginia	25
Washington	3
West Virginia	10
Western Pacific Territories	0
Wisconsin	108
Wyoming	1
Total, United States	844

Senator JEPSEN. All right. Thank you, Mr. Secretary. I'll advise the committee that we'll follow the 10-minute maximum rule today. I yield to the distinguished vice chairman, Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

Mr. Secretary, let me just express my support for the request that the chairman made with regard to this tax ruling. That's critical, it seems to me, for the American farmer.

Why can't the President of the United States call up the IRS and say, "I want a ruling on that?"

Mr. LESHER. Well, that would almost be like my requesting our Statistical Reporting Service to report to me a crop estimate of a certain size. You just can't do that. We pride ourselves with providing the most unbiased crop numbers we can come out with. The analogy would be for either myself or the Secretary to call up the Statistical Reporting Service and say, "Give us support for our program and don't come out with a very large corn crop."

Representative HAMILTON. You think that argument would sell to a group of farmers?

Mr. LESHER. Well, I'm not sure whether it would sell completely with the farmers. But it also isn't appropriate to force IRS to rule on a matter if it contradicts current law.

Representative HAMILTON. It doesn't sell very well to me. It just seems to me that a ruling so critical to the success of the program might be one that would take Presidential intervention. I don't want to argue the point. I just want to make the suggestion to you that I think it's so critical, Mr. Secretary, it's necessary to take direct action, probably from the President. Maybe it can be done by you. I don't know. But it's very important. I just want to stress that point.

Now the first question I have is, why don't we enter into a long-term grain agreement with the Soviet Union?

Secretary Block. I hope that maybe this year sometime that relationship can be such that we would be prepared to do that. The determination has not been made by the President that we are going to do that this year. We are living right now under an extension of the old agreement and it will extend through the end of September.

Representative Hamilton. You're going on the basis of 1-year agreements, are you not?

Secretary Block. Yes; we have a 1-year extension of the old agreement in place right now and the decision has not been made how to proceed.

Representative Hamilton. Well, I think you agree—and my time is relatively limited here—I think you agree from your comment that you would favor a long-term agreement with the Soviet Union. I would. I think most persons who represent agricultural areas would. I understand some of the opposition to it. I'm glad to hear you say that you support it and I hope you prevail in your councils with the President on that point.

Now, with regard to the PIK program or the payment-in-kind program. As I understand your testimony, that program is really not going to prevent us, the farmer, from suffering a fourth disastrous year. Even with that program and assuming the success of the program—we're going to have a very, very tough year for the farmer this year.

Secretary Block. It's not going to be an easy year with prices so low. However, I think it's going to be a better year as prices will strengthen some. I look for this year to be an improved year for a couple of reasons. First of all, the cost of doing business.

Representative Hamilton. Improved over 1982?

Secretary Block. Yes, improvement over 1982. The cost of doing business, the inflationary increase in the cost of operation is going to be almost zero—practically no increase at all. Interest rates are down substantially and we borrow lots of money in agriculture. On the price side, if this program is successful and we get a good signup, prices should improve modestly this year. I can't say how much, but if you look at the quotes on the Chicago Board of Trade right now, the future market, the market is anticipating some strength.

Representative Hamilton. You're not projecting higher net income for the farmer in 1983, are you?

Secretary Block. I personally think net from incomes may be up slightly.

Representative Hamilton. You are projecting higher income?

Mr. Lesher. Yes: that's our correct estimate. This number will be coming out in a few days in the Agriculture Outlook publication.

Representative Hamilton. It was $19 billion in 1982?

Mr. Lesher. Yes; that's our correct estimate. This number will be updated when we project net farm income for 1983.

Representative Hamilton. Didn't I hear the figure $15 to $19 billion put forward here as a projected net income figure?

Mr. LESHER. I think you heard someone say that earlier in the hearing. There's been no official projection in 1983. It's coming out within a few days in the next Agriculture Outlook publication.

Representative HAMILTON. Are you suggesting to me that it will be over $19 billion for 1983?

Mr. LESHER. It could be—I just don't know. I don't think it will be any lower. We've just got to obtain all the data before we develop the final forecast.

Representative HAMILTON. But your best judgement is that it will not be lower in 1983?

Mr. LESHER. Yes; because of what the Secretary said. Costs are coming down, and you've got a firming of market prices.

Representative HAMILTON. But as I understand the payment-in-kind program, these commodities are released on the market. Isn't that going to have a depressing effect on the market?

Secretary BLOCK. No. I get that question often and I appreciate the chance to respond to it. The commodities are not released onto the market until the normal harvest time. Indeed, Texas gets theirs before North Dakota would get theirs. So it's designed to simulate a normal harvest period. However, the producers won't be getting as much as they would normally be raising because, in the case of feedgrains, they will get 80 percent and in wheat 95 percent of their normal yields. They're taking out a certain amount of land to justify this payment-in-kind.

Furthermore, we are reducing the overall burdensome stocks and that in itself should provide some strength too.

Representative HAMILTON. Would you agree with me that this program actually increases government intervention in agriculture?

Secretary BLOCK. I would agree that this program——

Representative HAMILTON. Short term?

Secretary BLOCK. Short term, this program is unusual. It's innovative and it does put the Government in the business of providing stocks instead of money. I'm not so sure that it is any more intervention than is necessary. And after stocks are advanced, the Government can reduce its involvement in agriculture. Prices will be up.

Representative HAMILTON. There's certainly a lot more intervention in the area of land diversion.

Secretary BLOCK. That's right, there is. It's a short-term effort to adjust supply and demand the best we know how, to get ourselves back on an even footing.

Representative HAMILTON. Is the legality of it certain? There was a big dispute about this $50,000 limit, the farm payment limit. You're confident of the legality of this program, are you?

Secretary BLOCK. Yes, sir. Our attorneys reviewed it and we adjusted just a little bit to make sure it was strictly a payment-in-kind program. We're going to pay with crops and not with money and that's how we have been able to satisfy the stautory question.

Representative HAMILTON. And you don't need any authorization from the Congress at this point?

Secretary BLOCK. Well, I would not object to some clarification because you can always have a lawsuit that could tie things up a little bit, but we don't feel it's necessary.

Representative **Hamilton**. What does the President mean when he says in his state of the Union address that we must "help cash-short farmers get back on their feet?" These fellows are facing an enormous, immediate problem which can't wait until September; they're in trouble right now. The President, I think, recognizes that in his statement. What are you going to do about it?

Secretary **Block**. This program does help in that regard. Those that really have their backs to the wall, if they sign up in the program, they will be able to avoid the heavy operating costs of putting out a full crop. So it does address their problem up front. It addresses it in an immediate way by reducing their borrowing obligations this spring. Some of them are having a hard time getting credit anyway. Furthermore, some of them may choose and be successful in bidding in the whole farm in the program. If they take their whole farm out, they won't have any crop expenses except covercrops and other miscellaneous expenses.

Representative **Hamilton**. What kind of predictions are you making about the extent of participation in the program?

Secretary **Block**. Well, we've said that we may see 23 million acres taken out of production—about 10 million acres of wheat and 10 million acres of feedgrains and 3 million acres of rice and cotton. We have no track record so we have no way of knowing for sure, but we hope to cut the production of feedgrains and wheat by more than 1 billion bushels. Those are some of our expectations, but we have no way of making accurate predictions at this stage.

Representative **Hamilton**. Let me ask you about export subsidies. I take it from one of the statements you made in your prepared statement—where you say, "We favor using a greater share of our available public funds in aggressive programs to expand exports."—that we're really beginning to move into a substantial program of subsidies for agricultural exports. That's my impression. Is that an accurate impression or not? You had export subsidies on the Egyptian sale, did you not, in fact?

Secretary **Block**. Yes.

Representative **Hamilton**. You've got all of this competition from the European Community—it is heavily subsidized there. We've got to try to compete. And it seems to me that our answer is, "Subsidize exports in one way or another."

Secretary **Block**. The way I would explain our position is that, first of all, in the blended-credit program—I think you have to take the programs separately—what we really are doing is lowering our interest rates into a competitive range so countries will buy from us. Now with interest rates coming down around the world, it may not make a lot of difference. We may be only moving it down 2 percent or so. We're not bringing rates down to 4 percent or anything like that. Interest rates will be about 8, 9, or 10 percent. What we're trying to do is just be competitive in interest rates with other countries and most of these sales will be additional sales to the less developed countries. We're not doing it with the big industrialized countries.

The other thrust—the Egyptian flour arrangement—is a targeted thrust, like a rifle shot, not a shotgun blast, to a country where there's a market that we have seen taken away from us by a competitor in a way that we feel is unfair. That would be the European Community's export subsidies and we have only done one like this to date with the market in Egypt for the wheat-flour. I'm not going to predict we're going to do another one tomorrow.

Representative HAMILTON. Isn't that like a shot across the bow of the European Community?

Secretary BLOCK. I would characterize it as an effort to compete. Frankly, they have argued in the GATT, when we have argued against export subsidies, that subsidies are all right and within the rules of GATT. If they are within the rules of GATT, I guess we'll have to employ some of them. Otherwise, we'll lose the market.

Representative HAMILTON. Do you have any idea what we're spending now on export subsidies, and do you have any idea what's in the President's budget, for example, for export subsidies?

Secretary BLOCK. We don't have anything that you would call just export subsidies. We have $1.25 billion for blended credit. That is $250 million direct credit at no interest to blend with $1.0 billion other credit to reduce the effective rate applied to loans for purchases of agricultural commodities. So there's some subsidy in that if you take a strict definition. The other wheat-flour program used surplus grain. We didn't use resources out of the Treasury to make that deal attractive to Egypt but rather we took advantage of the surplus. We used our surpluses and I would say that if we do any more of this we will once again probably use surplus commodities rather than dollars.

Representative HAMILTON. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman. This has been a most interesting discussion for a city cousin to try and understand. I do understand bureaucracy a little bit and I do understand the problem that you're indicating you have with the IRS and how difficult it has been to get them to move. I suppose it's almost as difficult as supposing an NFL team which started with a record of 0–5 could possibly go to the Super Bowl in a year and a half. With that kind of attitude over at the IRS, I suppose if the Redskins had it they would still be at the bottom of the league. I certainly hope that whatever is necessary to get that ruling on a date certain so that you can find out whether in fact your program can go into effect is extremely important and I would be happy to join the chairman and I'm sure others that are not intimately involved in agriculture in seeing whatever is necessary to get that done.

You were talking about the trade requirements. Obviously, it's extremely important to the overall agricultural health of this country. And one specific question I have is, are you satisfied at this point with the progress, if there has been progress, that we're making in opening up the agricultural export market in Japan?

Secretary BLOCK. Well, I'm not satisfied with the progress that has been made to date. I am satisfied with the level of interest and the level of importance that everyone has placed on this issue.

An example would be, of course, that the President and I both met with the Prime Minister when he was here in the United States and the first issue on the agenda was opening the market for agricultural commodities, in particular, citrus and beef. But I can't say that I've seen any movement and I don't know when we will be going back for further negotiations.

We have met with them on several occasions but they had nothing to offer in those areas. Consequently, we said that we would just postpone futher meetings until they had something to come forward with. We have not put the meetings back on the schedule.

Legally there's no obligation for them to come to any decision or any solutions to be arrived at until April 1, 1984. So it's over a year. But certainly between now and that time I'd like to see some progress, but they do not appear to be in a big hurry.

Representative LUNGREN. Mr. Secretary, from your standpoint in terms of export trade in the agricultural industry, at least from your perspective, do you believe that we are seeing an appreciation for the problems of protectionism, whether it be through protection of your own domestic markets through tariffs and so forth or whether it is taking undue advantage through subsidies against your competitors? I mean, do you perceive that there's an appreciation of that problem with the countries with whom you have dealt in the past? Or are we running a risk right now of every country even more acutely being every man or every woman for himself or herself and depending on that perspective, what does that say about the way in which this administration should approach our attempts to expand our export market?

Secretary BLOCK. There is a very great risk for the United States if we move in the direction of protectionism. We should guard against this. We should encourage all of our trading partners to do this because legislation that provides for protectionism will only be met with retaliation and, frankly, from an agricultural standpoint, we have more to lose in agriculture than anyone else because we export so much.

Now I draw a very real distinction between protectionism and being aggressive in exporting and willing to compete with other countries. I think they are two separate issues. We're saying that we are going to guard against protectionism but still be competitive.

Representative LUNGREN. How do you deal, for instance, with the European Community where they say, for instance, we need to have some of these subsidies to protect our most essential producers and they say, "By the way, you in the United States have been doing this to a certain extent over the years." Specifically, what is our position in terms of talking with those countries when they say, "We would love to have a free market but you don't have a totally free market in the United States. You certainly don't have a completely free market in agriculture." Obviously, beauty is in the eye of the beholder and I imagine that that is a problem here, but how do we respond to that sort of argument by the European Community?

Secretary BLOCK. Well, there is a tremendous difference between their support program and our support program. What we have done essentially is provide for transfer payments, cash payments, to supplement farm income to producers who are hurting. In addition, we have price support laws to make sure market prices do not fall too low. So our farmers generally receive market prices and we make cash payments to supplement incomes.

What they do is lock the price in at a much higher level than the world market price which leads to excessive production and they subsidize the excess on the world market. Our producers live with the world market and it fluctuates in accordance with supply and demand factors. When the world market is down, our farmers are getting less money. In Europe, they have a fixed price which is substantially above the world market. When you have a fixed price well above the world market you encourage excessive production and what do you do with the excess production? Now they don't know what to do with it. They couldn't export in the world market at their prices because they are above world levels. They have to buy the price down to the world market level and slightly below and then dump it out into the world market.

We're not doing that in the United States and the concept of our support program, the loan rate for instance, is a safety net. In my prepared statement, I said it should serve as a safety net but it should not be the price. Their system has a support level which is the price.

Representative LUNGREN. And one of your suggestions is that we've made that mistake in the dairy support program?

Secretary BLOCK. That's right. In the dairy program, the support level became the price and it encouraged too much production.

Representative LUNGREN. Let me ask you a question on a little different subject. On the PIK program, how will it affect those other people who are employed in the agricultural support industries, for instance, those who are involved in the manufacture of supplies, fertilizer, etc., transportation of those supplies and so forth? Have you done some studies in terms of if this program were fully implemented how it would impact those other sectors?

Secretary BLOCK. Yes, sir. We have looked at that and there is some apprehension there. If we achieve the 23 million acres reduction we envision, that would mean a reduction of 13 percent of the acres that would have been in these crops—feedgrains, wheat, rice, and cotton. So we are talking about a 13-percent cut in acreage. It will be a smaller percent cut in the use of chemicals and fertilizers than the 13 percent, however. Producers will naturally put a little extra fertilizer and other inputs on the acres that they keep in production.

The input industries are generally supportive of this program, though, because they realize that their livelihood depends on a healthy, prosperous farming industry in the long run.

Representative LUNGREN. Mr. Secretary, just one last question and that is this: In your testimony today you have given to me as someone who doesn't have as extensive a background in agriculture some insights as to why you're doing some of these things and particularly why you're doing some of these things differently than what has been done in the past.

Let me just ask how you would answer a question that I'm often hit with in regard to agricultural programs, by constituents who ask:

> Look, we've got a problem of feeding the population of the world today. Why does this government support any program which would be geared toward lessening production and taking acreage out of production? Doesn't that, in a sense, create a problem with the global implications of a higher price for certain peoples of the world who can't afford the price that exists today?

Secretary **Block**. Well, the last thing we would do in this country would be to consciously reduce production in order to make short the food supply so people wouldn't have it available to them. But the fact is that stocks right now are ample in the world. The United States is holding 60 percent of the reserve stocks—more than we export in 1 year. The fact is, no one really wants these stocks. You can't sell them. We do have some programs that give some of it away, but you can only give so much away. So we didn't have any choice but to look for some adjustment until we could bring supply and demand into closer balance.

Mr. **Lesher**. The crucial thing that most don't seem to realize is that price is really not a factor in supplying food to the truly hungry around the world. Port facilities are limiting and the infrastructure within a country limits how much you can actually give away. We have asked the Congress to give us the authority to give some of our grain stocks away to the very, very poor around the world. But we realize that it would dispose of very little grain. It is much more of a humanitarian gesture.

Secretary **Block**. And we've already started doing this with our surplus dairy products. We have this authority with the dairy products. We don't have the authority with the other surpluses.

Mr. **Lesher**. We've pointed out that this is a humanitarian policy, not a policy to increase farm prices, because the amount that you can give away in those situations is not that great because of the port facilities, the infrastructure, and so forth.

Representative **Lungren**. Thank you, Mr. Secretary.

Senator **Jepsen**. Congressman Obey.

Representative **Obey**. Thank you, Mr. Chairman.

Mr. Secretary, I'd like to follow up on the domestic side of the coin. Congressman Lungren was talking about distributing food products. I'm trying to get some numbers here this morning. My understanding is that the Dole bill which has just been introduced would provide approximately $50 million to States to help them in the process of distributing surplus food products around the country to the poor. I have been told that that amount will enable the Government to provide distribution of just about 1 billion dollars' worth of food. Is that a correct number?

Secretary **Block**. I can't tell you how much it would provide for. We have not taken a position on the Dole bill. We are now distributing very, very large amounts of our dairy products in many States and it's being done primarily through volunteer efforts.

Representative **Obey**. What's your estimate of the Dole bill, if we provide that $50 million as he suggests? The Department must have some estimate of the amount of food products that we would be able to distribute with that money, or are we just shooting in the dark?

Secretary **Block**. Well, I don't have that figure. I'm not sure we've done an analysis on it at this point in time. Actually, you could probably operate it more than one way with the Federal Government providing a certain percent of the costs and have the State and local governments providing the remaining portion.

Representative **Obey**. I'm not trying to debate the Dole bill. I don't want to do that.

Secretary **Block**. But I don't know how much you can give away.

Representative **Obey**. I'm just trying to get your estimate. If we take Senator Dole's suggestion and pass it hook, line, and sinker with not a comma changed, what's your estimate of how much in existing Government-hold commodities we would be able to distribute under that proposal?

Secretary **Block**. I don't have that figure.

Mr. **Lesher**. We don't have it. I think a general answer would be that you can distribute some extra commodities if you're willing to pay the cost of processing the corn or other commodities into an edible human product. The limiting factor is that you cannot do very much of that until you run into displacement of commercial sales and then suddenly you run into a revolving door.

Representative **Obey**. You're getting into another argument here. I don't want to debate the bill with you. I would appreciate, if you don't have an answer to it, just tell me because we've got precious little time.

Secretary **Block**. We don't have an answer.

Representative **Obey**. Thank you. Now I would like to get parochial for a moment if I can. Everybody has talked here this morning about grain production and I don't blame them. I'd like to talk about dairy a little bit, coming from the country I come from.

You indicated that you thought milk production was probably going to go up this year rather than down?

Secretary **Block**. It went up last year and I'm not sure what will happen this year.

Representative **Obey**. What's your guess for this year? Any guess for this year?

Secretary **Block**. I don't think it will go up very much.

Representative **Obey**. But you think it will go up some?

Secretary **Block**. Yes, perhaps slightly.

Representative **Obey**. OK. What is your estimate of the cost of buying surplus dairy products for the coming year, costs to the Treasury?

Secretary **Block**. Just a little in excess of $2 billion.

Representative **Obey**. Versus what last year?

Secretary **Block**. About $2 billion. I think it will be about the same.

Representative **Obey**. Now, I'm told that the estimate of the average cost per hundredweight for purchase, handling, storage, administration, and so forth, the average cost to the Government turns out to be about $17 a hundred. Is that the figure your Department uses?

Secretary **Block**. That's what I understand.

Representative **Obey**. OK. Good. What is the level of surplus dairy products which the Government holds right now in milk equivalent?

Secretary **Block**. I can't give you the milk equivalent. I could give you a breakdown on nonfat dried milk and other dairy products. I can get those figures. Do you have them now, Bill?

Mr. **Lesher**. We have over 1 billion pounds of powder and about 400 million pounds of butter.

And about 800 million pounds of cheese.

Secretary **Block**. That's about the breakdown.

Representative OBEY. How much do you expect to purchase this year in milk equivalent? Do you have any idea?

Mr. LESHER. About 10.3 percent of the total milk production.

Representative OBEY. 10.3 percent?

Mr. LESHER. Yes. That's about 14 billion pounds of milk equivalent in excess that we purchase.

Representative OBEY. How long do you think it will be before the dairy surplus comes down to manageable levels and what would you suggest that that figure ought to be in order to be reasonable for the Government to have on hand?

Mr. LESHER. About 3 to 4 billion pounds milk equivalent is a reasonable amount. This is enough to service our domestic food programs.

Representative OBEY. How long do you think it's going to take under existing programs to get there?

Secretary BLOCK. Now we have a law that provides for 50 cents assessment against the dairyman and then another 50 cents to be enacted April 1. The first 50 cents had a court order that stayed that election and what we have done is we appealed the judge's order.

Representative OBEY. But assuming you win that?

Secretary BLOCK. Assuming we win that and the second 50 cents goes into effect, I think it will bring it down in time. I think it may take 2 or 3 years However, dairymen despise the plan and so do I.

Representative OBEY. I understand, but my time is short. Nobody has to tell me that dairymen despise it. You say 3 years?

Secretary BLOCK. I think in 3 years. That's just my guess.

Mr. LESHER. I don't think it's going to be before that.

Representative OBEY. You have presented a program to try to help grain farmers with the PIK program. Are you thinking of anything new or anything different to help the dairy farmers?

Secretary BLOCK. I have been meeting with the leaders of the dairy industry almost once a week and I've met with many Members of Congress on this issue.

Representative OBEY. Have you had an opportunity to talk to the Wisconsin Farm Bureau, the Wisconsin Farm Cooperatives, and so forth, about their new proposal for surplus reduction?

Secretary BLOCK. Yes, I have done that. The president of the Farm Bureau, Mr. Halderman, was in our office.

Representative OBEY. What's your reaction to that?

Secretary BLOCK. It might have some possibilities but one of the problems with it is that it's not necessarily that well received by other regions in the United States. The dairy industry is split region to region and it makes this issue very hard to deal with.

Representative OBEY. Let me just say, because I know that time is short here, I understand why regions who are contributing much more greatly to the increase in the surplus might be a little skittish about ideas that come from another part of the country.

But my favorite philosopher is Archie the Cockroach and Archie said a number of years ago that "Farmers have great political leverage in the control of the levers of production and their inability to get together is not an excuse for expanding their political power." I must say that I have been impressed because I have never seen before all of those farm organizations in my State get together on anything.

They are almost always shooting at each other as much as they are shooting at anything else.

I think it is highly significant when you get producers who are willing to take the heat for the 50 cents assessment which you're trying to get through that court right now and who are willing to try to come up with a proposal to help farmers while still avoiding costing the Government any additional money. I think it's highly unusual. I have not seen that kind of common mindset on the part of dairy producers in my State before and I would strongly urge you to give it a good strong look-see because while I don't consider myself to be an expert in the field of dairy economy obviously, I certainly do think that it is the most constructive idea I've seen to date for getting that surplus down in a much faster period of time than you indicated we'll get it down to under present law.

Thank you, Mr. Chairman.

Senator **Jepsen**. Congresswoman Holt.

Representative **Holt**. Thank you, Mr. Chairman.

Mr. Secretary, you mentioned—I'm not too versed in agricultural matter—but you mentioned that you were concerned about what's happening financially to the farmers with the Farmers Home Administration and that you're making efforts to avoid foreclosures without destroying the integrity of the farmers or the industry.

What about interest rates? Isn't that one of the biggest problems that the farmers are having today, high interest rates, and a lot of the purchases that were made at a high interest rate period? Is anything being done or are they simply just trying to let them stretch out their payments or what's happening?

Secretary **Block**. Interest rates are still a problem, even though we have seen a lot of progress in the last 2 years. As a result, the Farmers Home Administration under this administration has reduced interest rates on loans to farmers and others.

First of all, Farmers Home Administration, which is a Government lending institution, only provides money for about 12 percent of the credit in agriculture. It's not a big part, but that's a lending institution. I think our interest rates are down around 10 percent, depending on the program.

The Production Credit Associations, I would guess, are between 12 and 13 percent. My local farm bank, Farmers National Bank of Knoxville, Illinois, is currently at 13.225 percent for farm loans. It has been coming down and they are forecasting lower rates.

Representative **Holt**. There's considerable talk of some sort of international PIK program giving additional amounts of commodities out of Government-owned stocks for foreign programs. Do you have a program like that in mind or are you considering it or have you thought about it?

Secretary **Block**. We recently used surplus stocks to secure the market for wheat-flour in Egypt. If we had some legislation providing for the use of stocks in some way like this it would give us a little more flexibility. But I would want to reiterate that I don't think it's appropriate that we go out and indiscriminately pick off markets around the world with an export PIK program because what you're really doing is engaging in export subsidies to secure a market. We have many countries that I wouldn't want to do that to.

Representative HOLT. You said earlier that you were testing, that this was a trial balloon, but have you really studied the ramifications of it? Have you really proposed any kind of program along those lines other than Egypt?

Secretary BLOCK. Well, I would say that we could like to have the flexibility to use it again if we felt that we weren't making the kind of progress we'd like to see in our negotiations. We have the obligation to our industry to remain competitive. We can't just leave the agricultural industry hanging in midair as we lose our share of the market.

Representative HOLT. Now another problem, of course, that we all see is the strength of our dollar. In the President's state of the Union message he said that he will propose a broader trade strategy to promote the free trade and the increased flow of American goods and services giving a fair shake to American farmers. What does he have in mind? We have heard our monetary and fiscal experts say we really can't pay a lot of attention to the dollar as we try to restore our domestic economic strength, and it seems to me that the stronger that gets, the stronger the dollar is going to get. Isn't that pretty difficult to deal with?

Secretary BLOCK. Well, I guess none of us really know, but as our economy strengthens and improves, this should add or at least keep the dollar from becoming very weak. However, if our interest rates come down some more this should help weaken the dollar. Maybe the two will balance out. I would not look for a dramatic fall in the value of the dollar this year, though, because of what you have just suggested. That means when the President talks about the United States being aggressive in its export policies, we are using blended credits and we should be announcing some more sales soon.

Second, protecting our markets, as we have demonstrated in Egypt, and adopting an aggressive attitude toward exports—sending trade teams, working with the industry—are some of the ways we are addressing this. None of them alone guarantees success, especially under the conditions that we are operating today.

Do you have anything, Bill?

Mr. LESHER. I think some of the programs already announced—the blended-credit program and others—tend to offset some of the impact the strong dollar has had, and I would just say that as the U.S. economy turns around it will pull the rest of the world with it, and when that happens you're going to increase the value of their currencies, placing our dollar in a much better position.

Representative HOLT. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Senator JEPSEN. Do you have any further questions?

Representative LUNGREN. No.

Senator JEPSEN. Mr. Secretary, the United States and the European Economic Community negotiators will again be meeting in Brussels on February 9 to discuss trade conflicts. We have touched on this subject of free trade today, but with regard to that specific meeting, should we anticipate movement toward freer trade or agreements in market sharing schemes? Are you optimistic about that meeting?

Secretary **Block**. Well, the first meeting that we had the first week in January is going to be followed by another meeting the first week in February. That, I guess, is this week.

Mr. **Lesher**. He's leaving tomorrow.

Secretary **Block**. Mr. Lyng, the Deputy Secretary, will be going to Europe tomorrow for the second meeting. I think the first meeting was a constructive meeting. At least we tried to do something. A year ago I recall when I went to Europe with Secretary Haig, Secretary Regan, and Ambassador Brock, of all the issues we talked about the agricultural dispute was the last issue on the table and received the least amount of consideration. When I went this past December, the agricultural dispute is practically the only thing and the biggest thing on the table.

So finally we have arrived. Now can we get a solution? Well, we are going to keep at it. I hope so.

Senator **Jepsen**. Who's currently the Chairman of the European Economic Committee?

Secretary **Block**. President Thorn is the President of the Community.

Senator **Jepsen**. What nation is he from?

Secretary **Block**. I believe he is from Denmark.

Senator **Jepsen**. Denmark?

Secretary **Block**. No. It is Luxembourg.

Senator **Jepsen**. Well, I've visited with him. Are we going to have anybody along that can speak Finnish?

Secretary **Block**. He speaks English quite well. He understands, I assure you.

Senator **Jepsen**. Well, it might help to listen to them when they're discussing things, you know.

Secretary **Block**. You don't have to translate or anything else.

Senator **Jepsen**. In all seriousness, when we have people going to these meetings, do we have people who are bilingual? Do we have people who speak fluently the language of the country we would meet with?

Secretary **Block**. We have people in the Department of Agriculture who can do that for us and, if we don't, we use people from other departments. We are not handicapped in this regard at all.

Senator **Jepsen**. I'm not sure you answered my question. Are they with you? Do they accompany you? Do we have them present at these meetings?

Secretary **Block**. Yes. Often in these meetings you'll have interpreters. If you're going to have a real formal-type meeting, like you might have here in this room and where different languages are spoken, you would have interpreters. And when I would be speaking in one language, somebody else would be simultaneously interpreting what I would say in another language. There's really no problem that way.

Then when you go to dinner in an informal scene at night you find out everybody can speak English anyway.

Senator **Jepsen**. Do we share those interpreters? I'm just curious about the mechanics. Do we take our turn in having our guy in the box to insure that everything is being passed on, that it's one of our folks?

Secretary **Block**. Yes.

Senator **Jepsen**. In response to our imposition or purported imposition of restrictions on textile imports from the People's Republic of China. Didn't we impose restrictions on textile imports?

Secretary **Block**. It was necessary to negotiate a new agreement on textiles and the People's Republic of China was pressing for substantially higher increases in their quota. We were not able to agree with what they asked for and so the discussions broke down. And then, at least in my observation, in retaliation for our unwillingness to open the market up as much as they would have liked, they said they would not buy soybeans or cotton from the United States and would consider reducing their purchases of wheat and feedgrains.

Senator **Jepsen**. When these negotiations were in process, was it the Department of Agriculture that was negotiating or was this being performed by another department? Who was doing the negotiating?

Secretary **Block**. The negotiations on the textiles were handled by the Ambassador for Trade, Ambassador Brock, and of course we were quite aware of the negotiations but were not involved in them directly.

Senator **Jepsen**. Well, I'd like you to comment on that. We weren't involved directly in those negotiations, and yet the first thing that happened when it triggered a reaction from China was that the agricultural community and specifically the soybean producers were pointed out and singled out for retaliation. Shouldn't there be more coordination of effort in these negotiations? The hip bone is connected to the thigh bone and the thigh bone is connected to the—and so on and so forth.

There's an interrelationship here and should we continue to operate as separate entities within our own Government when we negotiate trade with other countries?

Secretary **Block**. No, we shouldn't and, frankly, we really don't operate as separate entities. Sometimes I wish I could be a little more separate from the other entities. In this case the administration had agreed to work at a certain level with the textile industry and it just broke down. We just couldn't provide, at least at the time, quite what the People's Republic of China was asking for. The People's Republic of China is playing hardball with us. There's no question about that, and I think we understand that. The day after this decision came out about 6 o'clock in the morning I met with Ambassador Brock and talked to Secretary Schultz about it. We all hoped that we could come to a resolution. We're going to be working on this further. We are in it with both feet and, as you say, these things do have a way of spilling over. That's why I cautioned you earlier about local content legislation. The first place that could probably spill over would be into agriculture.

Senator **Jepsen**. Absolutely.

Secretary **Block**. We'll pay the price. That's why the agricultural industry should oppose it with every bit of strength we have.

Senator **Jepsen**. Yes, and that's why the message and story needs to be told and communicated to the people in this country. They need to understand and appreciate the fact that 22 percent of U.S. exports are in the agriculture product area and that the black ink in the balance-of-trade payments primarily comes from the agricultural sector, the most productive segment of our economy. We're blessed with tremendous productivity in agriculture and we ought to work a little more hand-in-glove with all other departments in working out these various trade negotiations and agreements. I know your feeling, Mr. Secretary, and I know you have been sometimes an Horatio Alger and the only one taking a lead to bring people together—I appreciate your work.

Senator Mattingly, I would advise you that the Secretary does have a 12 noon appointment.

Senator MATTINGLY. I've got seven people in my office. I won't ask very many questions.

Secretary BLOCK. I'm supposed to be back at 12 for a budget meeting.

Senator MATTINGLY. I can tell you what's in it.

Secretary BLOCK. I believe I know, too.

Senator MATTINGLY. Right. To try to dissipate—I know you're going to run back and see it. We've already seen it Friday, the budget. In order to try to anticipate those deficits, they have already been talking about the trade issue and the wheat flour, but as you know, the American poultry has suffered a lot of losses in the market due to large subsidies made available by the European Economic Community and Brazil to the producers.

In light of your decision on the Egyptian flour sale, do you feel that you might be able to make some CCC surplus corn stocks available for our domestic producers to help them compete with producers with these unfair subsidies?

Secretary BLOCK. Senator, we haven't decided how to deal with the subsidies in other commodities, but I did point out earlier that the EEC has increased their part of that market up from 45 percent to 80 percent in the Middle East. And our portion of the Middle East market has dropped from 97 percent to 17 percent. It's pretty clear what's hapened to us and we must deal with it but I cannot say today what we will do. We would like to be prepared to do something if we find it necessary as we proceed with our negotiations with the European Community.

Senator MATTINGLY. As you well know, we don't want any protectionist measures, but there are things that can be done within the rules and regulations of GATT. One of them was the bill I introduced last year, S. 3049, which would have given you authority for foreign surpluses. I think also that excess portion of the PIK bill which I'm sure that you also agree that that could be done and it's not protectionist in nature but it's rather for a free market. Is that correct?

Secretary BLOCK. Yes, sir. Were it to be used on a targeted basis to make ourselves competitive. It needs to be targeted, however.

Senator MATTINGLY. One quick question and I'll let you go. If the legislation passed expressly giving you discretionary authority to utilize current surplus stocks do you think that you could take prompt action to actually make these commodities available to targeted areas?

Secretary BLOCK. We would do it in a very discretionary way. I would not predict how much we would use or where we would use it. It's my opinion that as we proceed with negotiations that we have to carefully evaluate the situation to insure the greatest amount of success. That has to be weighed with this other decision about the poultry and flour market, and it's all part of the mix. The decisions are not necessarily absolute or easy, but every consideration has to be weighed.

Senator **MATTINGLY**. Let me just say if you keep on doing it the way you've done it with the wheat-flour, you're on the right road, and if you'll just keep pursuing the same direction I'm sure you're going to succeed in getting our fair share back. Thank you.

Secretary **BLOCK**. Thank you.

Senator **JEPSEN**. I have been building a record here. The Federal Reserve Board, which, according to the statute legislation that was passed was supposed to have broad representation of membership. In your opinion, as Secretary of Agriculture, does the Federal Reserve, to the best of your knowledge, have someone who specifically is real knowledgeable and reflects and represents agriculture on the Board at this time?

Secretary **BLOCK**. I can't say that's necessarily true. I would say that as we were looking at appointments, I am hopeful that we could get someone that had a very good grasp and understanding of the agricultural industry—appreciating its importance to the nation.

Senator **JEPSEN**. Both small business and agriculture are supposed to have very specific representation on that Board. It's my feeling they are not represented and I asked that question to the Chairman of the Board the other day and he indicated to me that agriculture was not represented. And you agree and we will continue to build our case.

Secretary **BLOCK**. It's a good case, Mr. Chairman.

Senator **JEPSEN**. Thank you, and thank you very much for appearing.

Secretary **BLOCK**. I thank the committee.

Senator **JEPSEN**. The committee will stand in recess.

[Whereupon, at 11:55 a.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 2, 1983.]

THE 1983 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 2, 1983

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 6226, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Abdnor, Mattingly, Proxmire, and Sarbanes; and Representatives Hamilton, Hawkins, Scheuer, Holt, Lungren, and Snowe.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; Richard F. Kaufman, assistant director-general counsel; and William R. Buechner, Christopher J. Frenze, Louis C. Krauthoff II, and Mark R. Policinski, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator Jepsen. Gentlemen, it's a pleasure to have you before us once again. Mr. Feldstein, Mr. Niskanen, and Mr. Poole. In many ways, this visit is under much better economic conditions than existed the last time Mr. Feldstein was here, just 6 short weeks ago.

The recovery, from all indications, has begun. Leading economic indicators were up a very strong 1.5 percent in December. Housing starts are up 36 percent and housing permits are up 60 percent over 1 year ago. December auto sales were 25 percent higher than 1 year previous and the January figures look even better. The Consumer Price Index rose 3.9 percent for 1982, the lowest rate since 1972. Last year, wages grew faster than inflation for the first time in 4 years.

There is also good news on unemployment as weekly initial claims for unemployment have been cut by over 200,000 since September. In addition, the average work week for factories has increased over the past few months and there has been a large increase in the number of firms increasing employment. The callbacks at the auto companies are very good news because those jobs spin off a great number of jobs in other industries. We have a long way to go on unemployment but we have begun.

Though everyone agrees that the recovery is here, the really good news is that expectations of its strength are also turning more optimistic. This is the best news of all because unemployment will be reduced only if we have a sustained recovery.

What is somewhat curious to me is that the administration is about the most pessimistic group around. The chart on my right [indicating] shows how the administration's forecast compares with some other projections. Also, there's been some speculation that these private forecasts will be revised upward very soon. Now this would obviously make the administration's forecast even more pessimistic than the rest of the world and I must tell you, gentlemen that the whole world hopes that you're wrong.

[The chart referred to follows:]

FORECAST COMPARISONS

Real GNP Growth
(year-over-year)

	1983	1984
Wainwright Economics	5.7%	9.3%
Wharton	2.4	5.0
Merrill Lynch	2.2	4.8
Chase	2.1	3.9
DRI	1.6	4.5
Blue Chip Consensus	2.5	4.4
Administration	1.4	3.9

Senator **Jepsen**. In any event, the administration's estimate for real economic growth in 1983 of 1.4 percent is one of the lowest of all projections. In fact, Secretary Regan told us last week that of the 45 private forecasts that Treasury follows, almost 40 are more optimistic for economic growth in 1983.

Obviously, there is much more at stake than the reputation of various forecasts. Those 1 or 2 or 3 percentage point differences in economic growth rates can mean trillions in GNP, billions in income and millions in jobs over the years.

Just as importantly, different growth forecasts mean different deficit estimates mean different tax and spending actions by Congress. There is a growing fear that excessively high deficit estimates will cause Congress to pass new tax increases which will cut short the recovery. Those high deficit estimates will become a self-fulfilling prophecy.

What most concerns me is that the third year of the tax cut or indexing of the tax system will be abolished to reduce these estimated deficits. If we take away those tax cuts. We will be cutting short the recovery in future years. It will be a case of the administration's estimates being used to "do-in" the administration's program.

But there is a more basic reason why we should not take away those tax cuts. We promised them to the American people. They know about them, they expect them, and contrary to some of the rhetoric you hear around Washington, they want them. I hope that the President will veto any budget that takes these tax cuts away.

Gentlemen, again welcome. We look forward to the report and now I yield to the very distinguished vice chairman of this committee, Congressman Hamilton.

Representative Hamilton. Thank you very much, Mr. Chairman. Just a word of welcome to the members of the Council. We are delighted to have you here and we look forward to your testimony.

Senator Jepsen. Is there any other member of this committee who desires to make a statement or has an opening statement? [No response.]

Senator Abdnor has requested that his opening statement be made a part of the printed record, which I will do at this point, without objection.

[The opening statement of Senator Abdnor follows:]

Opening Statement of Senator Abdnor

Welcome, Mr. Feldstein, Mr. Niskanen, and Mr. Poole, according to the Economic Report of the President, the President's state of the Union message and dozens of news accounts, the economy is poised for recovery, if it hasn't already started. Evidence of a recovery include increases in the index of leading economic indicators during 7 of the last 8 months, a substantial rise in housing starts compared to a year earlier, a dramatic drop in inventory levels, and declining long-term and short-term interest rates. The administration predicts, and most private forecasters confirm, that the gross national product will begin to rise in the first quarter of 1983.

On Monday of this week Secretary of Agriculture John Block appeared before this committee and, when pressed, conceded that 1983 farm net income will likely be unchanged from its extremely depressed level of last year. Secretary Block made this comment: "It is important to realize that the factors affecting the farm economy are complex, and for the most part, beyond the direct control of anyone." I find this statement to be distressing.

While the Secretary and everyone associated with agriculture is hopeful that economic recovery will spin off some benefits to the agricultural community, they are likely to be modest relative to the economic stimulus needed. Ending the global recession is equally important to agriculture, but here too, I am fearful it may be too little too late. Real farm net income in 1982 was one-fourth the level realized by farmers 10 years ago and almost identical to farm net income in 1933. In addition, the real value of farmer-owned assets has dropped $100 billion during the last 2 years. Clearly a modest domestic economic recovery as forecast, followed perhaps years later by a modest world economic recovery, does not hold great promise for America's 2.4 million farm families.

While economic recovery is necessary it will not be sufficient to solve the income or deteriorating equity positions of U.S. farmers. To suggest otherwise is misleading and counterproductive. Secretary Block appraised traditional farm programs as inflexible and ineffective and concluded that we are just beginning to understand more fully the relationship between the economy and agriculture.

In my judgment this assessment could apply to several U.S. industries. With economic recovery now underway, our work has just begun. The real economic policy challenge lies ahead of us.

Senator Jepsen. All right. We will go directly to Mr. Feldstein.

STATEMENT OF HON. MARTIN S. FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY WILLIAM A. NISKANEN, JR., MEMBER; AND WILLIAM POOLE, MEMBER

Mr. Feldstein. Thank you very much, Mr. Chairman. I agree with you that conditions look a good deal better than they did just 6 weeks ago when I appeared before this committee the last time. Indeed, even the figures that became available yesterday reinforce the notion that the economy is moving forward in a much more positive way.

We saw that the new orders for manufacturing were up and moreover, for the first time this year, the backlog of unfilled orders has turned around. I think that's a clear indication that we will soon see a change in production and hiring behavior.

We are certainly very pleased to appear before this distinguished committee. I am personally honored to have the responsibility as Chairman of the Council of Economic Advisers to present the 37th Annual Report of the Council of Economic Advisers.

I shall begin this morning by describing the overall structure of the Report and by highlighting some of its principal conclusions. I will then focus in more detail on the administration's economic forecast and the forecasting philosophy behind that forecast.

THE ANNUAL REPORT

The Annual Report begins in chapter 1 by reviewing the economic experience of 1982 and the transition to recovery and sustained growth to which we now look forward. We point with considerable satisfaction to the dramatic reduction in inflation that occurred in 1982. The rate of inflation was brought to the lowest level in a decade, substantially moderating the earlier widespread fear that inflation might accelerate sharply in the years ahead. Unfortunately, the reduction in inflation was accompanied by a painful slowdown of the economy and a very undesirable rise in the rate of unemployment.

Some temporary decline in real economic activity was probably unavoidable in the process of reversing the upward trend in inflation. Reducing the rate of inflation requires a reduction in the rate of increase of nominal GNP, that is, of GNP measured at current prices. If prices and wages were perfectly flexible, reduced nominal GNP growth would translate immediately and painlessly into reduced inflation. However, the reality is that it takes time for a change in inflationary expectations, together with the direct pressures exerted by ex-excess supplies, to cause prices and wages to adjust to new market-clearing levels. Until that occurs, a slowdown in nominal GNP is reflected in a slowing of real growth as well as in a slowing of inflation. The reduced level of economic activity since 1980 has in large part been the price that the United States has paid for failing to control inflation in the late 1970's.

The severity of the recession in 1982 reflected a combination of circumstances that caused a very sharp decline in the growth of nominal GNP between 1981 and 1982, from a 9.6-percent rate of increase in 1981 to a 3.3-percent rate last year. Although some slowdown of nominal GNP growth was a predictable effect of tighter monetary policies, the very sharp decline actually experienced did not reflect a correspondingly large decrease in the growth of the monetary aggregates. Rather, the exceptional severity of the slowdown in nominal GNP growth reflected an unusually sharp decline in the velocity of money, that is, in the ratio of GNP to the money stock. Although the cause of the large velocity shift that occurred in 1982 is not fully understood, it is likely that major changes in the asset demands of individuals and businesses played an important role.

Chapter 1 goes on to discuss the principle and problems of implementing a stable monetary policy in the future when asset demands are changing rapidly. The administration has repeatedly indicated that the fundamental guiding principle of monetary policy in an inflationary economy should be a gradual reduction in the rate of growth of the money stock until a rate is achieved which is consistent with price stability. The basic challenge for monetary policy at present is to balance this principle of stable money growth with the need to take account of changing asset preferences that may alter the velocity of money.

There is no simple solution to the problem of guiding monetary policy in a time of rapid institutional and regulatory change. We believe strongly that targeting interest rates, either nominal or real, would prove to be a serious error. The monetary authorities should instead be guided by the principle of keeping money growth within a prespecified annual target range while adjusting those targets when a careful consideration of the evidence indicates that sustained shifts in asset demands have occurred.

Sound monetary policy is necessary but not sufficient for a healthy recovery and satisfactory long-term economic growth. A succession of large budget deficits would reduce substantially the rate of capital formation. Moreover, the adverse effects of large budget deficits are not limited to the distant future. The crowding out of private investment that would accompany large deficits could in the nearer term depress the level of output in the construction industry, the steel industry, the machinery and equipment industries. In addition, large budget deficits raise the exchange value of the dollar relative to foreign currencies, weakening the competitive position of U.S. exports in the world economy and hurting those of our domestic industries that compete with imports from abroad.

The prospect of large budget deficits in the second half of the decade may also have an adverse effect on the prospects for a sustainable recovery in 1983 and 1984. If the financial markets respond to expected future deficits by keeping real interest rates higher in 1983 than they would otherwise be, the level of spending in 1983 on interest sensitive purchases may remain depressed. Clear evidence of the willingness of the administration and the Congress to reduce Federal budget deficits substantially in the second half of the 1980's can play an important part in insuring a healthy and balanced economic recovery in the more immediate future.

UNEMPLOYMENT

Chapter 2 of the Report deals with unemployment, the most serious economic problem now facing the United States. The chapter analyzes the two major types of unemployment: cyclical and structural.

The statistical analysis of unemployment suggests several significant conclusions. First, even during recessions, most persons who become unemployed will relatively quickly either find jobs or leave the labor force. Second, the unemployment problem is most serious for those who are unemployed for prolonged stretches. Third, the incidence of long-term unemployment is very sensitive to cyclical conditions, which suggests that it will diminish as the economy recovers. But even after a recovery is well underway, a sizable fraction of total unemployment will involve prolonged joblessness. The needs of the long-term unemployed deserve special recognition in designing policies to attack structural unemployment. The other special problem group among the structurally unemployed is young people, many of whom have great difficulty in making the transition from school to relatively permanent jobs. The special problems of these two groups of the structurally unemployed and possible policies to deal with their problems are discussed in some detail in chapter 2.

The only way to reduce the current high level of cyclical unemployment is for the United States to achieve a sound and sustained recovery from the current recession. It is important, however, to recognize that avoiding further recurrences of high cyclical unemployment requires avoiding an expansion so rapid as to lead to increasing inflation. The administration favors as high a rate of economic growth in the coming years as is consistent with the goal of maintaining a sustainable expansion without increasing inflation.

The dual problems of cyclical and structural unemployment can be ameliorated by prudent public policy. Sound macroeconomic policies will avoid recurrences of the rising inflation of the 1970's and subsequent increases in cyclical unemployment. Policies directed at young people and the long-term unemployed, and reform of the unemployment insurance system, can significantly reduce the level of structural unemployment.

THE WORLD ECONOMY

The economic problems of the United States cannot be considered in isolation from the world economy. The third chapter of the report reviews the strains on the international economic system and the policies by which the United States can help to overcome them.

Concern over the international competitiveness of the United States is as high as it has ever been. Our analysis shows that although the recent appreciation of the dollar has created a temporary loss of competitiveness, the United States has not experienced a persistent loss of ability in selling its products on international markets. Of particular concern in 1982 has been the strength of the U.S. dollar, which rose against other major currencies to its highest level since the beginning of the floating exchange rates in 1973. The strength of the dollar provided some benefits to the U.S. economy by reducing import prices and thus accumulating progress against inflation. At the same time, however, the strong dollar causes severe problems for some U.S. industries by decreasing the cost competitiveness of exported U.S. goods and U.S. goods that compete in American domestic markets with imports from abroad.

The basic reason for the rise in the exchange value of the dollar has been the increased demand by foreigners for U.S. assets. Although this reflects in part the unsettled state of the world economy that has created a desire on the part of investors for a safe haven, the primary reason for the increased demand for U.S. assets is the unusually high real rates of interest in the United States relative to the real interest rates of other countries. Thus, the process of disinflation and the large deficits in the Federal budget have, by raising real interest rates, been the basic cause of the strong dollar and the large trade deficit. As these domestic macroeconomic problems are resolved, the problem of the dollar and the trade deficit should also be resolved.

The aim of the administration's trade policy must remain the preservation and extension of the benefits of free trade. In the pursuit of this aim, the United States must be willing to use its bargaining power to try to persuade other countries to abandon their trade distorting policies.

CAPITAL FORMATION

A subject that has been of particular professional interest to me for more than a decade is the problem of increasing capital formation. During the past two decades, a combination of fiscal, monetary, and regulatory policies has depressed the rate of net investment in plant and equipment, and has therefore lowered the rate of increase of productivity and real incomes. Chapter 4 of the report discusses the process of capital formation and the ways in which tax and budget policies impinge on capital formation.

The changes in tax rules and in financial regulations during the past 2 years have significantly improved the incentives for savings and investment. The decline in inflation has reinforced these changes since the interaction of high inflation with tax rules and financial regulations had tended to reduce real net-of-tax rates of return.

The primary remaining impediments to private capital formation are now temporary. The recession reduces capacity utilization and discourages business investment in plant and equipment. The large budget deficits mean that the Government is competing for funds that would otherwise be available for private investment. As the recovery develops and the budget deficits shrink, the administration's tax and regulatory policies will encourage higher rates of net investment than the United States has experienced in earlier years.

ECONOMIC REGULATION

The final broad subject that we discuss in this year's report is economic regulation. For many decades, the Federal Government has regulated the prices and conditions for entry in several sectors of the American economy. Whatever historical purposes were served by such economic regulation, there is an increasing consensus that much of this Federal regulation no longer serves the interest of the contemporary economy. Indeed, in the last several years, a substantial part of this economic regulation has been relaxed or eliminated.

Substantial evidence is now available concerning the performance of industries that have experienced full or partial deregulation. Chapter 5 of the report reviews this experience in relation to markets for energy, transportation, communications, and financial services. Our analysis finds that deregulation has generally had favorable effects on consumers and on the efficiency of resource allocation. Options for additional deregulation are discussed.

REVIEW OF 1982

The last chapter of the report provides a statistical review of the performance of the U.S. economy and of its principal sectors in 1982. The administration's economic forecast for 1983 through 1988 are also presented. Since the report does not discuss in detail either the forecast itself or our strategy of forecasting, I will now spend a few minutes discussing the forecast and our forecasting philosophy.

This may, Mr. Chairman, help you understand why we have made the forecast we did and why we don't feel we are as out of line with the thinking in the economics profession as the numbers that you show on the chart might suggest.

THE ECONOMIC FORECAST

In early January 1983, when the administration's economic forecast was completed, there was no clear evidence that an economic recovery had begun. The most recent available monthly evidence on production, employment, and the real volume of sales continued to show declines. Preliminary information indicated that real GNP had declined significantly in the final quarter of 1982. The economic statistics that have become available in the past few weeks confirm that December was a month of declining economic activity.

We nevertheless believed in early January that the economy would soon turn around and that the recovery was likely to begin sometime in the first half of 1983, most probably in the first quarter of the year. As of early January, the index of leading indicators had increased in 7 of the previous 8 months for which figures were then available. The most recent increase reflected favorable signs in labor, product, and financial markets. Those figures had just become available when I appeared earlier before your committee. We reflected our belief in an early recovery by forecasting a positive first quarter with GNP rising at an annual rate of 1 percent.

The December data that have become available since the forecast was completed—and I emphasize that—provide further support for the conclusion that a recovery will soon be underway. The Index of Leading Indicators for December rose 1.5 percent, the largest increase in more than 2 years. This rise in the index reflected an increase in new orders, a decline in new claims for unemployment insurance, an increase in building permits, and other favorable signs of an impending recovery.

The actual rate of growth in the first quarter of 1983 will depend on just when the recovery begins. If we eventually learn that December 1984 was the trough of the recession, the rate of growth in the first quarter of 1983 is likely to be significantly greater than the 1 percent that we forecast. But if the recovery does not begin until March, the rate of growth for the quarter as a whole could well be negative. The appropriate forecast for the first quarter of 1983 requires balancing the probabilities of alternative starting dates for the recovery.

If the recovery does begin in the first quarter of 1983, the rate of growth is likely to increase as the year progresses. It is possible that there could be some quarters of extremely rapid growth. The precise quarterly pattern is, however, very difficult to predict, especially since the date of the cycle trough is still technically not known.

The rate of economic growth in 1983 as a whole depends critically on just when the recovery begins. Our forecast of a 3.1-percent increase in real GNP between the fourth quarter of 1982 and the fourth quarter of 1983 reflects a balancing of probabilities of the different possible outcomes. If the recession reached bottom in December and the level of economic activity rises in January, the rate of real growth for the year as a whole could be significantly greater than 3 percent. If the recovery begins in January, I would not be at all surprised to see 5 percent real GNP growth in 1983. But if the start of the recovery is delayed until April and May, the real growth in 1983 could be less than 2 percent.

At the present time, I think it is still best to avoid the optimistic or pessimistic extremes and to use a forecast that represents a balance of probabilities. I believe that our forecast of [illegible]1 percent growth in 1983 is a cautious and prudent estimate that reduces the risks of unpleasant surprises without being unduly pessimistic.

All forecasts are inherently uncertain. The extent to which the uncertainty of a forecast impairs its usefulness depends on the purpose for which the forecast is intended. A business that wants to use an economic forecast to plan its near-term production and inventories would need a forecast that provides quite accurate short-term detail. A government that is trying to adjust monetary and fiscal policies continuously to prevent any unwanted fluctuations in real GNP would also need more accurate forecasts than we believe are possible. The primary purpose of the administration's economic forecast, however, is to serve as a basis for long-term economic budget planning.

It is significant, therefore, that the current forecast was prepared in conjunction with planning the budget for fiscal years 1984 through 1988. The budget for fiscal year 1983 was completed last year and is no longer a subject for decisionmaking. From a budgetary point of view, 1983 is relevant only because the rate of growth in 1983 influences the starting level of income in 1984. The specific quarterly pattern of changes in income and prices in fiscal year 1983 is therefore irrelevant since only their cumulative effect influences the outlook for fiscal year 1984.

Indeed, the primary attention on the forecast should be focused on the longer term outlook through 1988. I understand fully the difficulty of making such a forecast and the uncertainties that are associated with it. But a conscientious long-term forecast is better than no forecast at all. An analysis of the likely future path of the economy is the only way to reduce the risk of unpleasant surprises and to have a quantitative framework for long-term policy and budget changes. This is particularly important now when such a large portion of Federal Government outlays can only be changed slowly and as part of a long-term process.

Our strategy in making this longer term forecast is to focus on the overall trend in real GNP and not to attempt to forecast year-to-year fluctuations. We forecast a 4-percent rate of growth of real GNP in 1984 through 1988. We recognize that there will be some years in which real growth exceeds 4 percent and others in which it is less than 4 percent. But we don't pretend to have the ability to forecast these year-to-year oscillations. I would emphasize again that such detail is unnecessary for the purpose of shaping the budget and guiding the evolution of government programs. If economic activity exceeds our projection in some future year, the budget deficit will be smaller than we forecast; conversely, if the economy is weaker than our projection in some future year, the deficit will be larger. Such cyclical fluctuations in the deficit along a path toward budget balance are not inappropriate.

The increase in real GNP that we forecast implies that employment will rise by more than 2 million persons between the first quarter of this year and the first quarter of 1984 and that the economy will employ 14 million more people in 1988 than it does today. The resulting unemployment rate would be about 6.5 percent.

Forecasting inflation is certainly no easier than forecasting real GNP. Over the next 6 years, the price level will be subject to unpredictable shifts caused by events peculiar to the agricultural markets and the markets for raw materials. However, the basic path of inflation will depend on the monetary policy pursued by the Federal Reserve. Our forecast assumes that the Federal Reserve will continue to pursue a policy that is consistent with a gradual decline in inflation and we make no attempt to allow for transitory price shocks after 1983. In the near term, we assume that an end to the sharp decline in agricultural prices and a possible decline in the exchange value of the dollar will cause the GNP deflator to rise 5.6 percent between the fourth quarter of 1982 and the fourth quarter of 1983. After that we forecast a gradual decline in inflation to a rate of 4.4 percent in 1988.

In short, our forecasts calls for a long-lasting recovery and economic growth with declining inflation. It is important to have a sound recovery that can be sustained. Of the five recoveries in the past quarter century, only two lasted more than 4 years. The recovery that began in July 1980 lasted only a year. The recoveries of 1958 and 1970 lasted only 2 and 3 years respectively.

Our forecast of an expansion that continues without interruption for 6 years is therefore quite ambitious. The expectation that real growth will average 4 percent a year over the next 6 years is however both realistic and prudent. The average annual rate of increase to real GNP during the 6 years after the troughs of the seven postwar recessions was 4.2 percent. Despite the low level of the economy today, our growth forecast is very much in the middle of the postwar experience. Our forecast is, however ambitious in predicting a sustained expansion without increasing inflation. The two long-lasting expansions of the postwar period were accompanied by increasing inflation. When the 1961 recovery began, inflation was under 1 percent: by the time that the expansion reached its peak in 1969, the inflation rate had increased to more than 6 percent. The expansion in the second half of the 1970's saw inflation rise from less than 5 percent in 1976 to more than 13 percent in 1979.

A balanced recovery that permits sustained expansion without increasing inflation will not happen automatically. It requires a sound monetary policy and budgetary changes that shrink the Government deficits significantly during the coming year. I believe that the Federal Reserve appreciates the importance of pursuing a sound monetary policy and that the budget that the President submitted on January 31, indicates the budget savings that are necessary for a healthy recovery.

I very much hope that this committee and the Congress will join the administration in supporting these needed reforms in spending and taxes.

Thank you, Mr. Chairman.

Senator JEPSEN. Thank you, Chairman Feldstein, for a very meaningful, very concise annual economic report.

When you were president of the National Bureau of Economic Research, you said the current recession began in July 1981. Is this still the official starting date according to you?

Mr. FELDSTEIN. It is.

Senator JEPSEN. Now this is before the Reagan economic program was enacted, let alone before it was effective. I realize that the recession, which the President did not cause, and high interest rates, which the President did not cause, have been serious thorns in our economic sides, but isn't the Reagan program still the best medicine to get us out of the recession? Do you know of any responsible economists that advocate raising taxes during a recession?

Mr. FELDSTEIN. I have been for a long time a supporter of our economic program. I do think that it is the right program for keeping the inflation down, for giving us the kind of sustained recovery, and for giving us the high rates of real growth.

I don't know economists who would advocate at this time that we raise the rate of taxes before a recovery is fully launched and fully sustained. Of course, there are economists that advocate everything, so I'm sure there are some that hold that view, but I would hold that irresponsible.

Senator JEPSEN. Hobart Rowen, in a column in Sunday's Washington Post, said that "President Reagan is stubbornly sticking with a recipe for disaster," referring to the President's state of the Union message. Mr. Rowen went on to say that "Reaganomics is an utter failure." Further, he said:

> The harsh reality is that for all the rhetoric of accommodation and compromise, the President has stubbornly stuck to the key elements of Reaganomics that got us into the mess in the first place: a 25-percent cut in individual tax rates, followed by tax indexation due to begin in 1985; huge depreciation tax benefits for business; and a $1.6 trillion defense buildup.

The mess Mr. Rowen refers to is the problem of our enormous future deficits. Mr. Rowen says that sharp deficit reductions are desperately needed.

Now never mind that this whole thing didn't start until after July 1981, as you indicated, before the program was enacted, let alone before it was effective. But I would like your reaction to Mr. Rowen's article, to any of it or all of it.

Mr. FELDSTEIN. He said a lot of things in that paragraph that you read to me.

Senator JEPSEN. With all due respect, you know Mr. Rowen is here and we are glad he is.

Mr. FELDSTEIN. If you'll show me the paragraph I will be happy to comment on it in detail.

Let me start with the tax part that you referred to. Between 1980 and 1982, between the time the President was elected and the 1982 fiscal year, taxes as a share of GNP did not decline; they rose. In 1983 you will see the first decline in taxes as a share of GNP. I think the important thing in terms of controlling the deficit is not the deficit now, at the bottom of the recession, when everyone agrees that the major cause of the deficit is the depressed level of economic activity. About half of the current deficit is due to the fact that we are operating an economy which is far from full employment. I think the problem is bringing down the level of the deficit in future years and that's exactly what the President calls for.

The President's program recognizes that we have a deficit of 6.5 percent of GNP at the current time and, together with our forecast, which I emphasize is a very moderate, very prudent one, leads us to deficits which are a little more than 2 percent in 1988.

Senator JEPSEN. Do any of you other gentlemen care to comment?

Mr. NISKANEN. Yes, Mr. Chairman. I think Mr. Rowen may have the direction of causation backward. The recession clearly greatly increased the deficit. I think it is inappropriate to attribute the recession to the deficit. I don't know of any theory or body of evidence that would suggest that deficits cause recessions. The clear evidence, I think, is quite to the contrary. The recession was unfortunate and possibly an unavoidable consequence of trying to stop this 15 years of accelerating inflation and it was, as Marty has previously said, a painful success. The inflation rate is a third of what it was 2 years ago and we have gone through a wringer in the meantime largely as a consequence not of the fiscal actions but of the necessary monetary actions through disinflation.

Senator JEPSEN. I thank you. I'll go on the 5-minute basis today and recognize Congressman Hamilton.

Representative HAMILTON. Let me continue the discussion about the deficits for a moment, if I may. For a long time in this country, it seemed to me we wanted a balanced budget every year. That didn't work very well, and we decided we ought to balance the budget over the course of the business cycle. You seem to pay some respect to that doctrine in your statement, Mr. Feldstein, when you talk about the cyclical fluctuations in the deficit along a path toward budget balance. But we rejected that, too, because it didn't work, and we switched to a rationale saying that budgets should be figured in such a way as to promote high employment, and that seemed to be the rationale for deficits for a long time.

Now, frankly, with the deficits that you're projecting, I'm confused as to what the rationale is. You're projecting huge deficits by any measure, it seems to me, not just for 1983 and 1984, but on out, and those deficits include the Congress taking some steps which the Congress is not apt to take, as I think you know.

So what is the rationale for these gigantic deficits in the outyears, which even in the year 1986, by your projections, are $150 billion, and by other projections, might be even higher? We are told we cannot cure the recession without deficits, but as long as they persist we are not going to get sustained growth. I'm wondering whether the deficit is a cause of or a cure for an ailing economy. I'm really mixed up. What's your rationale for these horrendous deficits?

Mr. FELDSTEIN. I don't like deficits any more than you do.

Representative HAMILTON. Everybody says that. We all begin by saying we don't like deficits, and then we have huge deficits. Now, why?

Mr. FELDSTEIN. I think the problem is to find a way of bringing those deficits down as rapidly as possible. I don't think we should do it while the economy is just beginning a recovery. Once the recovery is well established, I would like to see those deficits come down more rapidly than we have forecast. I believe Dave Stockman and the President believed that if Congress would be willing to make more substantial cuts in spending then we would have proposed a budget that would have brought down the deficits even more rapidly.

What we have is an economy in which we are gradually shrinking the size of the deficit by allowing economic growth to increase tax receipts and to shrink the share of GNP going on Government outlays, moving toward a balanced budget. I would like to see that balance happen sooner than this. I don't believe that the deficit is an appropriate tool to be used for discretionary stabilization. Of the three stages of budget theories that you describe, I find myself much more comfortable with the second than with the third, with the view that we should be aiming for a budget balance or a certain level of surplus or deficit on a permanent basis, with regard to the amount of net capital formation we want contributed through the public sector, and then allowing cyclical fluctuations to raise that share up and down.

Representative HAMILTON. OK. Thank you. Because the time is brief, let me ask you a question about money policy. I'm not clear as to the kind of signals the administration is trying to send to the Federal Reserve with regard to money policy. The Secretary of the Treasury said in a speech a couple weeks ago, maybe a little longer, that we ought to have an accommodative money policy. When he was here last week, he didn't reject that phrasing, but he didn't use it, either, and I think he said that he didn't reject his previous language about an accommodative money policy.

I read through the economic report, and I don't know what you're trying to say to the Federal Reserve at the present time with regard to money policy. What are you trying to say to them? Are you trying to say to them, "Get those interest rates down," as the President recommended in the state of the Union address? Are you saying to them, "Stay the course"? Are you saying nothing to them?

Mr. FELDSTEIN. Both. I think the President was very clear in the state of the Union message about the reason that he thought those interest rates would come down. He said that it would be good to get interest rates down another 2 percentage points. He went on to point out that they were abnormally high, given current rates of inflation, and added that the only reason they were so high was that there was a fear out there in the financial markets, in the industrial markets and in the country as a whole—a fear that inflation might be rekindling.

By telling the Fed to stay the course, by making it clear to the public as a whole that that's what we are expecting from the Fed, a continuous non-accelerating growth of the money supply, we are hoping to convey that there shouldn't be that fear of inflation.

Representative HAMILTON. Did you accept the phrase that they ought to follow a more accommodative money policy?

Mr. FELDSTEIN. To economists, numbers sometimes speak louder than words.

Representative HAMILTON. But not all of us are economists, Mr. Feldstein.

Mr. FELDSTEIN. Let me therefore try to be clear about what accommodation means. I think if the Fed continues with the M_2 growth rate, the broad aggregate money growth rate, for next year that it said in

July it would aim for, about 6 to 9 percent range staying toward the top of it, that is consistent with the kind of real economic growth and inflation that we are forecasting. It is consistent with inflation being about 5 percent and real growth being about 4 percent.

Let me add one further thing on that point. This is, as the report emphasizes, a very difficult time because of the recent regulatory changes in financial markets. Those changes were good. They were important. They will make those markets work better. But they do make monetary policy tougher to do at this time and they make it even harder for people two steps removed from the Federal Reserve, from a detailed analysis of the statistics, to be sure about what's going on.

We are likely to see very much higher money growth rates during the next few months. This will not be an indication of accommodation. It will not be pouring oil on the fire. It will be a shift in assets into M_2 from outside M_2 and I think and I hope that financial markets and commentators will understand that accommodation is consistent with a moderating of inflation and a modest sustainable rate of economic growth. And what those numbers mean and what they reflect is simply a shift in assets.

Representative **Hamilton**. Do you think we can get sustained growth in the economy without the interest rates coming down?

Mr. **Feldstein**. I think the interest rates will come down as the participants in the financial markets recognize that inflation is under control. I think it will be very hard to get those real rates down if we don't see a change in budget deficits that are forecast for the second half of the 1980's. If we continue to have one-quarter of a trillion dollar budget deficits forecast for those outyears as we do under the current services budget, we are just not going to see those interest rates come down.

Representative **Hamilton**. That's all, Mr. Chairman. Thank you.

Senator **Jepsen**. Well, do you think we can get sustained rates of economic growth without the interest rates coming down?

Mr. **Feldstein**. There will be very feeble growth. We'll have a hard time—we will not have a healthy recovery. We will have a very weak growth. We will have very lopsided expansion. So I think it is really very important, but I want to emphasize that the only way to bring those rates down is by reducing the outyear deficits and by making clear to financial markets that inflation is going to be brought under control.

Senator **Jepsen**. Congresswoman Holt.

Representative **Holt**. Thank you, Mr. Chairman.

Thank you, gentlemen, for being here. I certainly agree that the confidence factor is the thing that we have to deal with. Your statement that the administration favors as high a rate of economic growth in the coming years as is consistent with the goal of maintaining a sustainable expansion without increasing inflation—that sounds like a big dream. But the thing that concerns me, that really frightens me—we're all worried about unemployment today and what we can do about it, and there's a great fear here in the Congress. During the 10 years that I've been here and served on the Budget Committee, I saw a real disaster in the form of a jobs creation bill. I think Mr. Schultz has been quoted as saying that was one of the serious mistakes that they made, and I know that you say that's not the way to deal with cyclical unemployment, but what do you think will happen if we do resort to that at this point, if we do pump $5 to $6 billion into some kind of jobs program?

Mr. **Feldstein**. Well, I fear that once again we may see Congress working itself up to a jobs program just at the wrong time. Congress generally launches job programs about 2 years too late. Regarding the experience that you referred to in the mid-1970's and the jobs program that began there, a subsequent study done by the Carter Office of Management and Budget concluded that the vast bulk of that spending only came onstream 2 years after recovery was well launched. I think it would be a mistake and I worry that it wouldn't just be a waste of $5 billion—not that that's not a good enough reason not to do it—but it would be another bad signal to financial markets that Congress just cannot control spending.

Representative **Holt**. In that experiment, didn't it fuel inflation?

Mr. **Feldstein**. Well, I'm more concerned not about it fueling inflation at this time as I am that, as I say, it would be a signal to financial markets that Congress cannot control spending. We would see long term interest rates rise and we would see the recovery just not taking off.

Representative **Holt**. Well, on the structural unemployment, do you favor providing training subsidies or tax incentives to employers?

Mr. **Feldstein**. I think the administration's proposals in that direction are very sound ones. I think they are really the kind of jobs programs that the Federal Government should be involved in, dealing with the imperfections in the market, dealing with the hardcore problems of young people who have a hard time making the transition from school to work, and with the long-term unemployed who suffer substantial and permanent hardship.

Representative **Holt**. Is it possible to define what the so-called natural rate of unemployment is? When we started in this recession, I think it was about 7.2 percent. Is that higher than the natural rate is now?

Mr. **Feldstein**. Well, different experts differ about that. It's not a number that stays put. It changes over time as institutions change. I would say that if one tried to estimate that today it would probably be somewhere in the 6- to 7-percent range. That is, we couldn't keep the unemployment rate below the 6- to 7-percent level without seeing inflation increasing unless we did it through structural policies. Of course, if we are successful in some of these structural unemployment policies—the target on young people, the disadvantaged, the long-term unemployed, training policies, and the like—then we can bring that natural rate down. There's nothing natural about the natural rate.

Representative **Holt**. On another subject, from your background as president of the National Bureau of Economic Research, along with your other background, would you say that most models today have been reworked to take into account the supply-side effects of the feedback from tax cuts? Are we really looking at that?

Mr. **Feldstein**. My impression is no, that most of the large econometric models do emphasize the demand side of the story. Many of the modelers have tried to incorporate some of the tax effects on investment and to a lesser extent the individual behavior, like savings behavior or labor supply behavior, but basically the emphasis on those models is on demand behavior rather than on the production side and the supply side.

Representative Holt. Thank you. Thank you, Mr. Chairman.

Senator Jepsen. Thank you. Senator Proxmire.

Senator Proxmire. Thank you, Mr. Chairman.

Mr. Feldstein, I'm encouraged by your forecasts because I think they are realistic and I think you deserve credit for it and I think it's the first time in many years we have had what I think are reasonable and cautious and prudent forecasts. It's natural for an administration to say that our policies are going to work and everything is going to be fine, but the forecasts in the past have been very bad.

On page 27 of the budget, for example, the forecast for nominal GNP was way off by a factor of about 300 percent. For real GNP they predicted a substantial growth and we had an actual fall, of course, in 1982. The predictions last year for inflation were also off by 300 to 400 percent, as was the unemployment forecast. So the record has been very bad.

On the other hand, you seem to put some confidence in your outyear forecasts and I can't for the life of me understand that. I think you're right in bed with the Farmers' Almanac on that, maybe with Jean Dixon, and examining the intestines of birds as the Romans used to do. When you go out 5 years there's no leading indicators. There's nothing. You can look at past history, but the situation now is entirely different.

Mr. Feldstein. What you cannot do—and I agree with you about this—you cannot look out to 1988 and say 1988 is going to be a recession year or a recovery year. What you can do is say, on average, over the next 6 years, the growth of the labor force, the growth of productivity, will produce certain average levels of real economic growth, and I think our figures and the Congressional Budget figures and many other private figures are very much in line because we are looking at long-term productivity plus labor force plus capital accumulation.

Senator Proxmire. Well, I appreciate that. I just wonder if it's of great value.

Now I want to ask you about the deficit. Suppose we forego the July 1983 scheduled tax reduction. I'm not talking about a tax increase. We have already had a 15-percent cut in the income tax. It's estimated that action would cut the deficit by $34 billion in 1984 and $150 billion in the period between 1984 and 1987.

Now yesterday the Washington Post reported that a poll they conducted asked this question of a cross section of Americans: "As you may well know, a 10-percent Federal income tax cut is scheduled to go into effect this summer. Do you think the tax cut should be canceled to help reduce the Federal deficit?" Now they received the following responses which I though were startling: 55 percent of the respondents said, "Yes, cancel the tax cut"; 39 percent said, "No." Incidentally, both Republicans and Democrats were about in the same proportion. Perhaps the Republicans were a little more emphatic in rejecting the tax cut and I think that indicates how strongly people in this country feel about the deficit and I think it's a remarkable degree of economic sophistication.

Now in light of the fact that in my experience—and I have been in politics a long time and I have run statewide nine times for office—the toughest thing you can get people to say is they don't want a tax cut or they want a tax increase. Now we're getting that. It seems to me there's good reason for Congress to respond here. It's equitable; it's just, to forego that tax cut. It would also provide a share reduction in the deficit.

I think that would be the best possible signal to the economy, to the investors and so forth, that we are serious about getting the deficit down and about the prospect that we can get inflation and interest rates under control.

Mr. **Feldstein**. Well, I do think it would be bad medicine for the economy at this point to see taxes increased.

Senator **Proxmire**. Why? We are not increasing taxes, no.

Mr. **Feldstein**. I understand what you said. I heard your words, but let me tell you the numbers. In 1983 taxes were taking 18.7 percent of GNP. Under the administration's taxes it will take 18.8 percent in 1984. If we have—I think your number was $34 billion increase in tax receipts, that's about another 1 percent. We'll see taxes go up to 19.9 percent, nearly 20 percent. So we'll see taxes increase as a percentage of GNP and, of course, GNP is rising as well, so the dollar value is going up even more. So there would be a substantial increase, about a $50 billion increase.

Senator **Proxmire**. Mr. Feldstein, that's an astonishing response when you have been telling us about this deficit. In 1984, after all, we would be well on the way to recovery in 1984. This wouldn't take effect for several months. We would all expect by July that we would have recovery underway. You still would have a very, very substantial deficit.

Mr. **Feldstein**. I agree you would have a deficit, but it is a tax increase. The question we have to ask is, at this point, as consumers are building confidence, as consumers are getting ready to help us get out of this, we want to say, "Sorry, stop, reconsider, what we are going to do now is increase taxes by $34 billion in 1984."

Senator **Proxmire**. But you don't increase the income tax. The income tax has been reduced. It's not going to be increased.

Mr. **Feldstein**. We still have bracket creep. We still have inflation. We are going to see taxes taking a higher share of people's income.

Senator **Proxmire**. You know where it takes a higher share because as time goes on we're going to have higher payroll taxes, regressive taxes.

Mr. **Feldstein**. Just the personal income tax alone will cause them to pay a higher share because of the bracket creep that would occur between now and 1984. I don't think there's any question about that.

Senator **Proxmire**. Well, my time is up, Mr. Chairman. I'll be back.

Senator **Jepsen**. Senator Mattingly.

Senator **Mattingly**. Thank you, Mr. Chairman.

Mr. Feldstein, it's good to see you here today. I promise not to quote the Washington Post or Hobart Rowen or anybody else.

Do you make recommendations for the budget in your capacity?

Mr. **Feldstein**. I participate internally in all the budget discussions.

Senator **Mattingly**. All right. We keep talking about we want a sound and sustained recovery and you say that comes from a sound and sustained budget policy and monetary policy, and you went on to make the comment that the Reagan budget will insure that type of recovery.

It's my opinion that the budget is out of control. Now anybody can be my guest to say that the budget is in control. I say it's out of control. I think the proposed budget that came out in the state of the Union message is not a controlled budget. I think that it will make monetary policy impossible as far as being reliable. There's still going to be the fear out there of having nonreliable interest rates not knowing whether they're coming up or down. We're going to have a nonreliable tax policy because of such comments about doing away with the third year of the tax cut or somebody putting something in the budget saying we're going to put a trigger tax out here in a few years. I think that also makes savings and investment decisions by individuals very unstable in our country, which all stems from a lack of consistency which I think gets back to you about what you were talking about, about forecasting, and I would say I would probably agree with you that probably the only thing you can forecast is for 1 year to have any reliability.

Now what I'm heading for is the comment that was made about the budget—about freezing the budget—because I just happen to disagree with what they were referring to in that budget, how they're freezing, because it is not a fair and equitable freeze. It freezes some things for 6 months and some things for 12 months.

The question I want to ask you because I feel like the only way to control the budget and give stability to the monetary policy or to the people of our country is in fact to freeze the budget, the outlays for fiscal year 1984, at the fiscal year 1983 level; that that in fact is the only way to make agencies, whether they be run by the best Democrat or the best Republican, to make the reforms necessary in those agencies.

The question I would ask you is—it may be a blunt tool, but our sophisticated methods have failed in this country, what this country has used, the recommendations that have come from the economic advisers—what harm do you see of mandating a freeze on outlays at the proposed $805 billion for fiscal year 1983 and having the same thing for fiscal year 1984?

Mr. **Feldstein**. Well, as a technical matter, you really couldn't do that line by line, agency by agency. There's no way to freeze unemployment insurance benefits.

Senator **Mattingly**. As the man said, it's impossible? But it's not impossible; it's just difficult: is that correct?

Mr. **Feldstein**. No, I think in this case it would be technically impossible to do, but nevertheless I think the administration really does share your basic philosophy. What we want to do is put a freeze on the overall program.

Senator **Mattingly**. How about if we just talk about functions and not line items?

Mr. **Feldstein**. You could do it to broad functions. The administration has tried to do something which involves applying a little more judgment than that. It's not a mechanical——

Senator MATTINGLY. Do you think it's good judgment to freeze one thing for 6 months in one sector of the budget and another sector for 12 months?

Mr. FELDSTEIN. I take it you're talking about the social security arrangement?

Senator MATTINGLY. Whatever.

Mr. FELDSTEIN. Well, the social security arrangement was something which, as you know, was worked out very carefully with participation by both parties, both houses, and it has the endorsement of the Speaker; it has the endorsement of the congressional Senate membership of that committee, as well as the President. That's a tough subject to find a compromise on and I think it's a very reassuring compromise.

Senator MATTINGLY. I agree with you that it's tough, but that doesn't mean it's impossible. The budget freeze that I propose and what I have introduced legislation on, which many other people will, would freeze everything except the interest on the national debt and new people who come into social security or people who come into medicare or what have you.

Mr. FELDSTEIN. Well, if you look at the 1983 level, you can't freeze interest. You have to pay interest on the debt. It's a big category. It's $89 billion this year. We estimate $103 billion next year. A lot of interest recipients would be unhappy if they don't get that interest paid. If you take the nondefense, noninterest, it's as close to a freeze as you can find without a magnifying glass. It's $502 billion in 1983 and the estimate for 1984 is $500 billion.

Senator MATTINGLY. If we froze all the entitlement and all index programs for 12 months and it can be done, nobody would get less. No program would get less.

Mr. FELDSTEIN. You would get more people retiring. You can't change the demographics.

Senator MATTINGLY. I know, but what I'm saying is you take the new people on that came into the system but you would in fact freeze the index program. There are 90 index programs, 44 entitlement programs.

Mr. FELDSTEIN. By far, the largest—80 percent of all the index dollars—go to social security.

Senator MATTINGLY. Not the index programs.

Mr. FELDSTEIN. The truly indexed programs, I think that's right, not being paid, but actually indexed programs.

Senator MATTINGLY. I'm talking about pay too.

Mr. FELDSTEIN. Well, pay is not an indexed program, but the extent of the social security freeze came from the Social Security Commission compromise.

With respect to pay, of course, it's a 1-year freeze, just what you want.

Senator MATTINGLY. I'm on your side.

Mr. FELDSTEIN. I knew that.

Senator MATTINGLY. But I think we talk about the economic indicators looking good, but they look good because we've had a weak economy. The interest rates are going down. They haven't come down because of what this Congress has done. They have come down because we have a weak economy.

Mr. FELDSTEIN. I would say they have come down because inflation has come down.

Senator MATTINGLY. That's true, too, but my final statement would be that the economic indicators may look good, but the budget looks bad.

Mr. FELDSTEIN. I agree with that and I think it's very important that we move to the budget that the administration has proposed.

Senator MATTINGLY. I would ask you to maybe recommend that we move a little bit closer to a total freeze across the board which would assure safety for the rest of the people of the country, not only Congress. Thank you. My time is up.

Senator JEPSEN. Thank you. Congressman Hawkins.

Representative HAWKINS. Mr. Feldstein, I suppose my statements will indicate that I'm not on your side. I cannot agree with some of the statements you have made. They seem to be as inconsistent as most of the other statements made by administration witnesses.

You made the statement this morning, for example, that job programs are two years too late and yet, by admission, you indicate that unemployment will be at very high levels for another decade or throughout the rest of this decade and in 1987 will just be back where it was when the administration took over; in other words, still above 7 percent.

Now if that is so, then it would certainly be, in my opinion, wise to have a jobs program in 1987 if you don't have one before that. That's ignoring the present 12 million unemployed people.

You indicated that you didn't think we could have high economic growth which would put people to work unless we also had structural policies and programs. Well, no one has ever suggested that we wouldn't use structural policies and programs, including a jobs program. So that it seems to me that that statement is absolutely without any value whatsoever to this discussion.

I'd like to remind the members of this committee that in 1976 a report was printed by the Joint Economic Committee publishing the results of a study by Mr. Harvey Brenner of the Johns Hopkins University which documented that a 1.4-percent rise in unemployment during 1970 accounted for 51,570 more deaths between 1970 and 1975 than would have occurred had the unemployment rate not risen in 1970. Now this was when the unemployment rate was below 6 percent.

Now looking at the actual consequences of the administration's policies, it would seem to me that we are not just talking about deficits and assets and a lot of other economic terms, but we're talking about the actual human consequences of continued high levels of unemployment. So we have a human factor concerned. We've got to be humane about the fact that there are 12 million unemployed people and that the administration, by its own admission, is suggesting a growth rate of 3.1 percent and a long-range growth rate in the neighborhood of 4 percent for the rest of this administration and into another administration, and that expert testimony would indicate that that is absolutely too low a growth rate to take care of even the annual increase in the labor force not to say anything about decreasing unemployment.

Last Sunday the Secretary of the Treasury, Mr. Regan, on national television, when asked, "What would it take to reduce the deficit, to get deficits down and get recovery," responded that it would take from 5 to 5.5 percent growth. This is another administration witness indicating something sharply different from the projections in the economic report and from the testimony today.

Now this itself is very low historically over a long period of time and if we haven't learned from history, why do we keep making the same mistakes?

Yesterday, before another committee on the House side, Lester Thurow of MIT indicated that the current policies are disastrous. Let's not talk about Hobart Rowen. Let's talk about other economists who are saying the same thing. He said yesterday, and I quote him, "The current economic disaster is not necessary," and then he went on to deal with the monetary policy saying that with such real interest rates no sustained economic recovery is possible. And he indicated in his testimony which I don't have the time to read that it would take a 6- or 7-percent economic growth rate to bring us out of this present depression. He's not the only one.

A year ago, Mr. Galbraith of Harvard indicated that monetarism and supply-side economics wouldn't work. We were told a year ago that they wouldn't, that you had to have economic growth of a substantial nature, including structural programs to spur recovery. The same thing has been said just recently, as a matter of fact this month, by Mr. Tobin in the U.S. News & World Report in which he indicated that your policies are nothing but a disaster and that you were not going through the mathematics that you're dealing with to get us back on recovery.

This economic report doesn't respond to the law which says that you're not here to forecast; you're here to bring in specific programs to reach certain goals, and it's pretty obvious that you're not setting goals. You're trying to forecast what is going to happen and that to me is a deficient part of this administration, that you act as if you have nothing to do with what is happening on interest rates, on reducing unemployment, on spurring the economy to get the growth which is necessary to do the job.

I think, as an American, it's sad to think that we're looking at a recession. It's a disaster. We're looking at another recession before this one is over because by your own projections that's all we can get into. It just seems to me you'd better get your act together before we have this situation deteriorated to the point that we pull not only ourselves down but the rest of the world with us.

I understand my time is up, but I thought it was just necessary to get something into the record that human beings are involved and it's just something more than these cold projections and that the problem isn't going to be solved statistically by changing definitions.

Mr. FELDSTEIN. Mr. Chairman, do I have some time to comment on that?

Senator JEPSEN. I think you should.

Mr. FELDSTEIN. Thank you. We have no disagreement about the importance of getting unemployment down. As we said in the report, unemployment is the most important problem facing our economy. I also believe that the only way to get unemployment down is by a sustained recovery. I believe that a sustained, continuing broad-based recovery is the best job program our economy can have.

Let me comment on some of the specific things which you said. I didn't hear Secretary Regan last week, but the number 5 to 5.5 percent rings a bell. If we have growth in the 5- to 5.5-percent range for every year from now until 1988, we'll have a balanced budget in 1988 and I'm sure that's what he was saying rather than saying that he believed we were going to have 5 or 5.5 percent from now until then.

Representative HAWKINS. He said that that was necessary.

Mr. FELDSTEIN. Necessity is a matter of arithmetic. If you want to have a zero deficit in 1988 you need a 5.33 percent growth of real GNP between now and then given our inflation forecast, but it's not necessary for a healthy recovery. It's not necessary to bring the unemployment rate down. Indeed, it would require a remarkable increase in the trend of productivity and potential GNP for it to occur.

Second, you said that our forecasts were not calling for a fast enough increase in output to keep up with the annual increase in the labor force. That's not true. The annual increase in the labor force is such that with our 4 percent real rate of growth, unemployment is continually coming down. The unemployment rate would reach 6.5 percent in 1988. So that it was falling more than 4 percentage points between now and then. It is more than keeping up with the rate of growth in the labor force.

Representative HAWKINS. You didn't indicate how you would bring it down. You're saying it's going to come down, but you have not indicated a single program, including economic growth, that will bring it down.

Mr. FELDSTEIN. Allow me to explain in more detail.

Representative HAWKINS. Well, give us some specifics on how you propose to do it with that low economic growth rate when you don't have a single economist that will indicate to you that that low economic growth rate could possibly employ people. With the increased labor force each year, with increased productivity, you're going to have more unemployment. You, yourself, are projecting continued high unemployment rates.

Mr. FELDSTEIN. I think you will find that virtually every economist would agree that, roughly speaking, an extra 1 percent real growth will reduce the unemployment rate by about four-tenths of 1 percent, so that the amount of real growth that we have projected is sufficient to bring down the unemployment rate over that period. The labor force is now growing at 4 percent.

Now you asked me to be specific rather than just numerical. As I mentioned when I began testifying, the most recent statistics to come out indicated that the backlog of orders for manufacturing firms has begun at last to increase. You may not call that an economic program. I do. That means to private firms that the time has come to start producing more, to call back the workers that they have laid off, to go out and find new workers and hire them. That's the only way we're going to get employment up.

As you know, we have 5 million people that are cyclically unemployed. The labor force is going to grow by another 9 million between now and 1988. You can't design jobs programs to hire 14 million people. What you can do is to have a healthy, sustainable recovery, and that's exactly what the administration is planning for, hoping for, and predicting.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Mr. Feldstein, there are two things that concern me when I look at the President's budget. One, of course, was the short-term and long-term deficits and the size of those deficits and also the still high rates of unemployment. Even until 1986 it's only reduced to 7.8 percent based on the President's projections.

Now the President's budget met with mixed reviews by Wall Street economists. I guess the good news, based on their reflections, was the fact that the President's budget was realistic in their assumptions, but the bad news was still the overwhelming size of the deficits.

If the Congress wanted to go above and beyond the President's budget deficit reduction program, what choices would Congress have to reduce the deficit even further? Could we reduce defense, health, not give the tax cut, raise taxes—and I agree with you, I don't think this is an appropriate time to raise taxes. What other options do we have to reduce the size of the deficit, considering the fact that the President would not support any of these options?

Mr. FELDSTEIN. I think our specific budget proposals on the spending side were put forward in a very restrained way because we believed that Congress is not prepared to make bigger spending cuts at this time. When David Stockman testified yesterday with me at the Appropriations Committee in the House, he pointed out to the members who raised the kind of question you're asking, the specific programs that they have resisted cutting in previous years. So there's no shortage of programs which the administration believes are wasted and that ought to be reduced further. Frankly, it has been the growth of domestic spending over the last 20 years that has created this very large level of outlays with which we are currently trying to cope.

So if the Congress wants to cut, I'm sure we will be happy to help you find additional ways.

Representative SNOWE. In defense?

Mr. FELDSTEIN. I think that you know that the President feels very strongly that it would be inappropriate to reduce the level of expenditure on defense. I think it is a very sad commentary that people continue to view defense in short-run budget terms, asking themselves whether "we can afford to spend another $10 or $20 billion on defense."

Back in 1960 when we were a much poorer country, we were spending 9.1 percent of GNP on defense. We allowed that to keep drifting down and down and down to 5.5 percent by 1980. What the administration's program would do is build it up gradually to a point where in 1988 it still will only be 7.9 percent of GNP, a lower percentage of GNP than it was back in 1960, and lower than it was in 1970. I don't think there's any question about our Nation's ability to make that kind of commitment to defense.

Representative SNOWE. Mr. Volcker has indicated in recent weeks that obviously he's concerned about the size of the budget deficits and that they could be and would be a threat to recovery. He's also indicated in questions from members of the committee the other day when he appeared before this committee that what he was most concerned about was not the deficits in the current year but in the outyears and the fact that we could have the inevitable collision between the demand for Treasury borrowing and demand by the private sector.

Now I know the administration has proposed the standby tax. Why would we want to wait until 1985 when the economy is growing, such as the contingency plan, the deficit would be 2.5 percent of GNP, and that we have enacted a deficit reduction program similar to the President's recommendation or the President's recommendation? Why would we want to wait until 1985 to trigger that tax increase?

And then, second, would you accept a deferral of tax indexing for 2 years, as has been proposed?

Mr. FELDSTEIN. Regarding the question of why we would want to wait first, I think it would be inappropriate for us to have a tax increase at this time. I said why in answer to a previous question. I don't believe that Congress is prepared to have a tax increase in 1984. Years divisible by 4 are tough years for tax increases. So I think we're really talking about 1985 as the time when realistically it makes both economic sense and is politically feasible for there to be a tax increase. And 1985 is the year, as you said, that this tax increase would go into effect. And that really would provide the reassurance for financial markets. The trigger is a very ingenuous device because it's a way of saying to the financial markets, "Don't worry, if there is very substantial real economic growth, if the deficits come down for other reasons, there won't be the tax increase; but the deficit will be small." "But if that doesn't happen, if our forecasts turn out to be about right, then in fact this fail-safe mechanism will take over and we will cut the deficit by another percentage point of GNP."

I think it would be a great mistake to postpone indexing. I think indexing is one of the most important things Congress has done in the tax area ever. I think it is the most important thing it has done to personal taxation. I think that it really changes the whole dynamics of our tax policy for the indefinite future. It puts a discipline on taxes. It puts Congresses on notice that the only way to spend more is to explicitly raise taxes. I think it would immensely improve our tax structure with its predictability and its controllability. I think postponing it runs a serious risk of postponing it again and postponing it again until it gets forgotten.

Representative SNOWE. Thank you.

Senator JEPSEN. Senator Sarbanes.

Senator SARBANES. Chairman Feldstein, do you think that defense spending increases contribute to the deficit?

Mr. FELDSTEIN. As a matter of arithmetic, yes.

Senator SARBANES. And do you think that tax cuts contribute to the deficit?

Mr. FELDSTEIN. The deficit, as you and I both know, is the difference between what the Government spends and what the Government takes in, so yes.

Senator SARBANES. Did you have anything to do with the Presidents state of the Union message?

Mr. FELDSTEIN. I did.

Senator SARBANES. How could you permit a paragraph asserting that neither the defense spending increases nor the tax cuts had anything to do with contributing to the deficit?

Mr. Feldstein. I can't remember the exact words. No doubt you will remind me of them in a minute. But I can tell you the intent of that paragraph and I think it is very accurate.

If you take not a month-to-month view of what's been happening or a year to year view, but if you look at where our budget has been going in a fundamental sense, there's no question that the reason that we have large deficits now has not been the increase in defense spending and has not been a reduction in taxes, but instead has been a sharp increase in domestic spending.

Since 1960, as a percentage of GNP, defense has come down by a third.

Senator Sarbanes. You keep coming back to this percentage of GNP. I'd like to pursue that for a bit. What is the magic figure of the percentage of GNP that ought to be spent on defense?

Mr. Feldstein. I do not know.

Senator Sarbanes. You don't know. What good does it do us, then, to bounce around these figures about the percentage of GNP? What is the percentage of GNP that ought to be taken in taxes? What's the magic figure?

Mr. Feldstein. I don't think there is a magic figure for that either, but I thought you were asking a different question before.

Senator Sarbanes. Now the healthier the economy is and the larger the GNP, the smaller the percentage a fixed tax bite would take; is that correct?

Mr. Feldstein. That is correct.

Senator Sarbanes. What would the percentage of GNP taken in taxes be today if GNP was at full employment levels with current tax rates?

Mr. Feldstein. It would be 19.3 percent in 1983.

Senator Sarbanes. At a full employment GNP?

Mr. Feldstein. At 6.5-percent unemployment rate.

Senator Sarbanes. Do you regard 6.5-percent unemployment now as a full employment rate?

Mr. Feldstein. Well, full employment is a word.

Senator Sarbanes. You sort of indicated that to Representative Holt.

Mr. Feldstein. Well, full employment is a word I try not to use, but I think it is the rate that most economists would say provides a kind of floor below which we cannot move the unemployment rate and keep it for a sustained period of time except by structural policy.

Senator Sarbanes. All right. I don't want to argue that point, although I differ with you; I think that figure is too high. But leaving that to one side for the moment, what deficit do you project when you project a 6.5-percent unemployment rate?

Mr. Feldstein. For what year?

Senator Sarbanes. Well, for what year do you project the 6.5-percent unemployment rate?

Mr. Feldstein. 1988.

Senator Sarbanes. What deficit do you project?

Mr. Feldstein. Well, we actually predict a 6.8 percent for 1988 but 6.5 percent in 1988 would produce a deficit of $106 billion.

Senator Sarbanes. That's assuming the contingency taxes?

Mr. Feldstein. That assumes the standby tax.

Senator **Sarbanes**. What's the deficit without the standby tax?

Mr. **Feldstein**. About another $50 billion.

Senator **Sarbanes**. How can you give us $106 billion as a projected deficit and at the same time an unemployment figure which you have just stated cannot be brought down by stimulating the economy; that is, by running this large deficit, without contributing directly to inflation?

Mr. **Feldstein**. I'm not sure that I understand the question. How can you do it? It follows from the numbers.

Senator **Sarbanes**. You regard that as responsible policy?

Mr. **Feldstein**. It is not what I wold like. I would like to see spending come down faster.

Senator **Sarbanes**. But you think cutting domestic spending is the only way to reduce the deficit?

Mr. **Feldstein**. I think it's an appropriate way to reduce the deficit. We have doubled it as a share of GNP in the last two decades. I think it is the primary place to look.

Senator **Sarbanes**. How else can you reduce the deficit?

Mr. **Feldstein**. You can reduce the deficit by getting down the interest payments. You can reduce the deficits by reducing defense spending. You can reduce the deficits by reducing defense spending. You can reduce it by increasing taxes. You can reduce it by having a higher rate of nominal GNP.

Senator **Sarbanes**. Did it occur to you that the Congress and the country might accept with a great sigh of relief an economic program from the administration that addressed the deficit question by also turning to the defense spending issue and the revenue base?

Mr. **Feldstein**. Well, as I said before, we are going to have, whether we like it or not—we are going to have an increase in taxes. This is not a budget that refuses to increase taxes. Taxes as a share of GNP are 18.7 percent, we estimate this year, and they will rise to 20.6 percent of GNP in 1988. So there is a substantial increase in taxes, 1.9 percent of GNP. At the same time, outlays come down by 2.2 percent of GNP. So roughly, it's a 50–50 split between now and 1988 in shrinking that deficit.

Senator **Sarbanes**. Isn't one reason why the deficits aren't seen to be moving down in 1985 and 1986 the pace of the economic recovery?

Mr. **Feldstein**. They would move down faster if we had a faster recovery and that may happen.

Senator **Sarbanes**. I understand one of the reasons you argue now for insisting on the third year of the tax cut is that you see that as impeding economic recovery; is that correct?

Mr. **Feldstein**. The failure to have it would impede economic recovery.

Senator **Sarbanes**. Would you not make the same argument in 1985 and 1986 if recovery were slow, in terms of a tax increase at that time?

Mr. **Feldstein**. If the economy were actually heading back down again, if the recovery were petering out, I would be nervous, but the standby tax is specifically designed with that in mind. If the economy is in recession again at that time, the standby tax would not take effect.

Senator **Sarbanes**. I'm going to come around again. I want to make this point to you. I think that the Congress and the country would welcome and be prepared to move ahead with an economic recovery program that addressed the large increases in defense, 14 percent in this budget, 9 to 10 percent in real terms, and addressed the revenue question by deferring the third year of the tax cut and indexation. Such a package would enable you to project in future years a far better deficit situation even as the economy moved back toward a full employment level. And the only thing that's preventing the Nation from moving to that sensible and responsible economic policy is the stubbornness of the administration on that issue.

Senator Jepsen. Congressman Lungren.

Representative Lungren. Thank you, Mr. Chairman.

Chairman Feldstein, just to set the record straight here, a minute ago the reference was made to the Gallop poll. I received in my office a copy of a poll commissioned by the National Chamber of Commerce and when asked if taxes had to be increased in order to bring the deficit down which taxes the American people would like to see increased, for your information, the lowest percentage, 14 percent, said remove the third year of the tax cut. When asked if they wanted the third year cut, by better than a two-to-one margin, 22 percent of the American people said they wanted the third year of the tax cut.

I happen to be one of those that don't believe in raising taxes since we are at historically high tax levels now. I don't think it makes sense to increase taxes in a recession and I'm not sure it makes sense to do it when the economy is coming out of a recession especially if the rates are already historically high.

When I go home to my district, I generally poll everybody who turns out to a town hall meeting and ask them a simple question: "Do you feel you are fundamentally undertaxed?" I think that's an honest and open way of asking it. We dance around here in Washington. There are some economists who suggest and some commentators, Mr. George Will among them, who say we are fundamentally undertaxed. I think we ought not to lose sight of the fact that the American people think we're fundamentally overspending.

With respect to the question of defense, I thought Senator Tower did an admirable job yesterday in suggesting how we might go about cutting defense when he asked all Members of the Senate to send in within a certain time a letter delineating those areas of defense cuts that affected their district which they are prepared to accept.

I know how that comes home because I just got a call yesterday from shipbuilders in my district who are concerned about the loss of jobs that will take place in and around my district because of decisions made by this administration to cut certain spending in defense. It is not as easy a suggestion as some may have us believe. It carries with it implications for jobs. I also think it carries with it implications for the primary responsibility for the Federal Government.

One of the things that troubles me when we have forums like this is that we direct questions to you asking why the administration's policies aren't better and why you are not achieving economic growth at a faster rate. I think perhaps it is more consistent with historical perspective to compare what we are doing and where we are now with where we would be had we continued to follow the policies that preceded this administration.

Have you given any thought to that? That is, what the state of the economy would be now if we had continued double digit inflation for

2 more years, if the prime interest rate were running 21.5 percent now, what impact that would be on the current state of the economy and the implications for unemployment?

Mr. FELDSTEIN. Well, I think you describe a situation which is clearly unsustainable. The inflation rate moved from about 6 percent in the mid-1970's up to 12 and 13 percent by 1979 and 1980. If we allowed that to continue, if we allowed inflation to go on getting higher and higher, I shudder to think of what it would do, destroying the markets, undermining capital formation, changing our whole economy. Ultimately, probably sooner rather than later, that would have to come to an end and the higher the inflation rate from which we tried to come down, the more devastating would be its impact on employment and jobs.

Representative LUNGREN. That's one of the questions I'd like to pursue with you. You made a statement, in your testimony, in which you said, "Sound macroeconomic policies to avoid recurrences of the rising inflation of the 1970's and subsequent increases in cyclical unemployment." I had charted for me those rates of unemployment that we had in the recessions that had occurred in the last 15 years and I believe there is an absolute pattern established that in each recession the cyclical unemployment was higher and in fact the plateau of unemployment from which we began recovery was up as well as the inflationary rate.

I guess my question is this. We talk oftentimes about whether we are pursuing policies to bring inflation down that of themselves cause unemployment. My question is this. If you allow inflation to continue unabated until such time as the American people say, "Enough, do something about it," do you not set the stage for ever-higher plateaus of unemployment which exists during the recessionary period and thereafter in the recovery unless you make fundamental changes in economic policy?

Mr. FELDSTEIN. Well, I think we've made that change. I think one of the reasons we're suffering with the current very severe recession is that we have come down from such an extremely high and rapidly accelerating rate of inflation, and I agree with what you're saying that if we had allowed it to continue, get to a higher level, then the fall would have been even more painful.

Representative LUNGREN. The point I'm trying to make is that we often hear discussions that somehow the administration is not concerned about unemployment. Those of us who are concerned about righting the economy are following what has been known as supply-side economics and getting inflation down. Yet some claim we are devoid of concern for the unemployed, and yet if you go back and look at it historically, every period when we allowed inflation in the postwar period to go ever higher, virtually irrespective of which administration is in power and what policies they pursued to bring inflation down, unemployment does go up to a greater degree. So it's almost setting the table for unemployment when you allow those types of Government policies that create that inflation and I just think we lose perspective when we don't talk about that and when we assume American people are no longer concerned about inflation.

My time is up. I'm sorry. I have a lot of other questions. I appreciate your comments. Thank you, Mr. Chairman.

Senator **Jepsen**. Senator Abdnor.

Senator **Abdnor**. Thank you, Mr. Chairman.

I have the same concerns that all the other members of the committee have but I have one area in which I'd like to go into a little more detail.

What do you consider to be the biggest single industry of this country?

Mr. **Feldstein**. The biggest single industry?

Senator **Abdnor**. In assets, production, and indirect and direct jobs?

Mr. **Feldstein**. I think statistically the answer is undoubtedly agriculture.

Senator **Abdnor**. I'm glad to hear you say that.

Mr. **Feldstein**. I got an A on that quiz.

Senator **Abdnor**. I was afraid you'd tell me something else and I would probably go straight through the roof. I've seen panels of economists come in time and time again and say we don't have something directly designed for the agricultural situation. There's never any mention of it. You do mention them at one point in your statement. Among your economists in your Council of economists, do you have an agriculture member?

Mr. **Feldstein**. We have a very fine member of our staff who does the staff work on agriculture and Mr. Niskanen is a member of the Council who looks after agricultural issues, although I have been involved in some of them myself.

Senator **Abdnor**. I hope you gentlemen all do have a feel for agriculture because I've watched and listened intently to groups of economists with big names and different areas of expertise, but hardly ever do they refer to agriculture. I don't want to belabor it to death, but I just think we should give it recognition.

Mr. **Feldstein**. Senator, one of the things I did mention in my prepared statement which we were discussing before is what is happening to exports in the past year. When you ask what part of the economy suffered the largest decline because of exports, it was agricultural products. I think the problems of the farmers are not just the problem of exceptionally large crops this year. I think one of the reasons why our farmers are suffering is that the high value of the dollar has made it hard for us to export those crops to the world market.

Senator **Abdnor**. But you know, what bothers me with almost every administration that's been in since I've been around here, whether it's Democrat or Republican, any time something might help agriculture, prices go up. Then the administration apologizes to the consumer for the increase in their food prices or they want to assume them that there will not be an increase in consumer prices. How in the blazes are we going to get agricultural prices up a little more if you don't get people to pay a little more? Have you got any thoughts on that? We brag about how we held food prices down, while farmers are going broke. I think you agree with that. With the condition facing farmers today, it's imperative that something happens. But if we're going to go on the assumption that we can't let food prices go up because it's going to be inflationary, we're in trouble. I wonder if you have any real thoughts on that?

Mr. **Feldstein**. Well, on that specific point, as I said, we think that food prices will probably rise in the coming year. There are natural fluctuations in the food prices and we expect to see prices rise. There's no intent to change that.

Senator **Abdnor**. It's got to. All three of you gentlemen, wouldn't you agree that we've got to get food prices up, whether we like it or not, if we're going to do anything for the farmer?

Mr. **Feldstein**. You're talking about the relative price of food.

Senator **Abdnor**. That's the end result of agricultural products rising in price. Somebody has got to pay for them. What portion of the food dollar goes to the farmer? I think it's a third.

Senator **Proxmire**. It's about one-third.

Senator **Abdnor**. One-third. So food keeps going up. Well, I don't think there's any secret that it isn't going to the farmer. Food processors are able to recover some of the additional costs, the inflationary costs of marketing the product. They make sure they add that to it, but the farmer's profit keeps going down, down, down. The net farm income, are you aware that today it's going to be less in real dollars than it was in the thirties? We said that last year and it's lower this year than it was last year. That's the thing that bothers me. We had John Block here and I'm sorry I had to miss it, but he conceded that the 1983 farm income will likely be unchanged from the depressed level it is today. Well, here we talk about economic recovery and that's great, but do you see much of an economic recovery for the farmer in this recovery?

Mr. **Feldstein**. I think the critical factor in terms of the farmer's ability to sell his products is to be able to export them. There are really two factors. One of them, as you well know, is that the agricultural policies pursued by some of our European allies make it very hard for farmers to sell products not only in Europe but in third markets. We have been very serious in making clear to the members of the European Economic Community that we think that their policies are really unacceptable and that the continued subsidy of exports by those countries and by the EEC is hurting our farmers and it's something that we just don't want to have continued.

I think the other thing about exports, though, is the very strong dollar and, as I said earlier this morning, that is largely a reflection of the very large Government deficits in the outyears.

Senator **Abdnor**. I'm glad to hear you say that and I also keep pressing the administration. I think PIK as a program is fine. We've got to cut back some of the production, but we can keep cutting back and pretty soon we'll be out of the export market. A 10-percent cut in wheat acres could be offset by all the other countries of the world by just increasing theirs by 2 percent and they're going to go merrily along producing as much as ever.

One last point I want to make, and I hope you keep it in mind when we talk about unemployment. Agricultural States like mine—we're the prize of the Nation—have a 5.5 or 6 percent unemployment. What it doesn't show is we've got an awful lot of people who go to work every day without getting paid. In fact it is costing them money to go to work. They're not getting an unemployment check. Low profitability shows—as Senator Jepsen who comes from Iowa knows—every time the farmer starts his tractor up it's costing money for the pleasure of going to work. He may be employed and won't show up in the unemployment statistics, and he certainly plays a role in the economic statistics, but he's not getting paid. Thank you.

Senator **Jepsen**. Thank you. One quick question before I proceed to Senator Proxmire. We haven't discussed much about the foreign international economy and how our economy is related to that.

Hearing the word "exports" reminds me that I believe the administration is asking for a quota increase for the IMF.

Mr. **Feldstein**. Yes.

Senator **Jepsen**. And IMF is also asking for it and 162 other nations are thinking about putting more in. Would you comment on what your feelings are about that and relate it to the economic welfare of our country as it relates to the rest of the world?

Mr. **Feldstein**. I'd be happy to. The International Monetary Fund, as you know, plays a very critical role in providing short-term assistance to countries that have balance of payments problems. It's not like the World Bank, an aid program to developing countries. Rather, it aids industrial as well as developing countries on a short-term basis, a few years, when they have balance of payments problems.

They've been playing a very crucial role recently in dealing with the problems of Mexico, Brazil, Argentina, Yugoslavia, and elsewhere. Those countries have found that a combination of circumstances has caused a sharp deterioration in their balance of payments. They have found that their export prices have dropped sharply. At the same time, they are paying very high interest rates on their dollar denominated debt. Moreover, the general slowdown in the world economy has made it hard for them to export.

As a result, they have not been able to earn enough from their exports to finance their critically needed imports plus interest payments on their oversea debt. The IMF has stepped in and the U.S. Government has stepped in and brought together the private bankers who are the primary lenders to those countries and helped them to organize a rescheduling of payments in an orderly way.

I think that we can be proud of the role that our Government has played in that as well as the role that the IMF has played.

In order to go on doing that, the IMF has got to be not merely an organizer, a market maker, but it also has to be able to put in some of its own funds. What the IMF does is borrow—I emphasize the word borrow—it borrows from member countries and then relends through commercial bankers to these other countries that are having temporary problems of meeting their balance of payments.

What the administration will ask for and what other governments will be asking their parliaments for will be an increase in funds that we lend to the IMF on which we get interest and which the IMF in turn can leverage with private money not only with American bankers but with bankers around the world in continuing to keep the Brazils, the Mexicos, the Argentinas, and others functioning because if that doesn't happen we are all in terrible trouble. If that doesn't happen, the entire trading system as we know it is in bad shape.

Senator **Jepsen**. Congressman Scheuer.

Representative **Scheuer**. Thank you, Mr. Chairman.

I enjoyed your testimony, Mr. Feldstein. I'm sorry I had to be absent for a few minutes.

There are two questions that I think all of us here on both sides of this table are very concerned with and they are problems you address in your statement. First, the problem of structural unemployment, especialy among our young people, the business of having a growing underclass in our society of young people who don't have job skills, who don't have literacy skills, is a horrifying prospect to anybody interested in the health of our society, let alone the health of our economy.

The second problem that we're all concerned with is our ability to compete in global competition, the ability of American corporations to produce goods and services that can make it in global trade.

Do you have comprehensive programs to address these two problems that you will be sending to the Congress?

Mr. FELDSTEIN. Well, they are two quite separate problems, of course.

Representative SCHEUER. Yes, of course, completely separate, although let me add that one of them impinges on the other. One of the reasons the Japanese have been able so successfully to introduce automation and robotics is they had a very literate, very productive labor force that does not resist the institution of labor-saving systems of all kinds, including robotics, because they know virtually every member of that labor force is susceptible if his job is being eliminated—susceptible of having his skills upgraded and perhaps getting a better job.

Mr. FELDSTEIN. There are a number of things that the administration has either announced or formally proposed which are aimed at dealing with this problem of young people. The targeted jobs tax credit was changed in a way to go into effect this summer. That makes it virtually free for employers to hire young people—85-percent tax credit against the wages that they pay. I think that will help a lot of young people not merely get jobs but get jobs that might give them more useful experience.

Along the same line, the administration will be proposing that during the summer months young people who are looking for summer jobs would be able to work at 75 percent of the minimum wage. The Job Training Partnership Act provides funds for specific training programs through the private industry councils which will focus on helping young people and other disadvantaged groups get jobs. So I think the administration is very sensitive to that issue.

With respect to trade, I think one has to distinguish the effect of the exchange rate from the other policies that influence our ability to export and compete with the products from abroad.

Much has been done through corrective programs on the unfair practices of other countries—blocking our imports there, subsidizing exports to our markets and into third markets. I can assure you this is something that the administration is very sensitive to and we are continuing to work hard on it, but frankly, it's tough. The GATT meeting did not produce the kind of results we wanted and negotiations on agriculture proceed very slowly. We will continue to persist and be willing to show that we're prepared to use our resources, to use our bargaining leverage, to get other countries to take notice of the fact that we believe in free trade and we want them to play by these rules.

That means expanding our Exim facilities so that if other countries insist on subsidizing exports we can come back and say, "No, you can't take markets from us that way; we can meet you head-on."

But I think the more fundamental thing and the thing around which we really are going to turn around our large trade deficit is the value of the dollar. And the value of the dollar, as I indicated in my statement, rose in the last few years because of the very high real interest rates and it's likely to stay very high until there's clear evidence that the deficits in the outyears are coming down.

Representative **Scheuer**. How about improvements in our domestic economy and our domestic institutional arrangements which seem not to produce an adequate rate of investment in research and development, and would not seem to produce an adequate rate of investment in new plant and equipment? We have seen corporations like the U.S. Steel Co. disinvesting for a generation or more while they are investing their cash flow in international conglomerates and buying oil companies that are quite foreign to their mission of producing cheap steel. Perhaps some hard look at the antitrust laws passed in the last century that may inhibit collective effort to produce a product like an automobile?

In global markets, is there any plan to have a comprehensive look-see at domestic impediments to productivity?

Mr. **Feldstein**. Yes, there is careful consideration, particularly the thing you just mentioned and other things in which Government policy has put into place in a different time for different reasons, restrictions which may currently be impeding us in our role as an international competitor.

Representative **Scheuer**. Has this comprehensive look-see——

Mr. **Feldstein**. It is currently taking place; yes. I frankly don't know how much is now public, so I'm reluctant to say much about what it is we're doing, but I can assure you that work is going on.

Representative **Scheuer**. Thank you, Mr. Chairman.

Senator **Jepsen**. The Chair would advise the committee that it will now start the second round and I would ask Mr. Feldstein, can you spend another 15 or 20 minutes?

Mr. **Feldstein**. Yes.

Senator **Jepsen**. Mr. Poole, do you have any statement you want to make for the record?

Mr. **Poole**. No.

Senator **Jepsen**. How about you, Mr. Niskanen?

Mr. **Niskanen**. No.

Senator **Jepsen**. On that basis, we will start the second round with the people that are here. We will continue with the 5 minutes and the Chair will recognize Congressman Lungren.

Representative **Lungren**. Thank you, Mr. Chairman.

I think I will direct this question to both Mr. Feldstein and Mr. Poole.

With respect to what the Federal Reserve is doing now, Mr. Feldstein, you seem to give more credence to the M_2 marks and when Secretary Regan was here the other day it seemed to me he was stressing M_1 a little bit more, although he talked about the difficulty in really defining what's in M_1 these days because of the deregulation we've had in financial institutions. Can you describe for me succinctly what it is the Federal Reserve is doing right now? That is, are they looking at M_1, M_2? Are they looking at a combination of both? What should they be looking at? And I agree that we want a stable monetary policy that is not inflationary, but yet is expansionary enough that we get the economy moving, but I believe there are a lot of things that I don't fully understand, and I wonder if maybe you could both comment on that.

Mr. **Feldstein**. Well, I'll take a crack at it and then Mr. Poole can give you his answer as well.

I've decided M_2 is the more important measure. The Fed has recently said that it's temporarily not looking at M_1 because of the problems associated with the transition that I mentioned earlier. I think that after the situation stabilizes, which may be a matter of 6 months, we will be in a situation where we can begin looking at both M_1 and M_2 again.

Representative **Lungren**. What are they looking at now? We know they're not quite looking at M_1 but what are they looking at?

Mr. **Feldstein**. I think they are paying more attention to broader aggregates, M_2 and M_3, because there has been this major change in regulations, the creation of money markets and deposit accounts, which has attracted very large amounts of funds. They are looking very hard at things that are not usually mentioned in theoretical articles. They're looking at the liquidity that lies outside M_2 and M_3 that are flowing back into M_2 and M_3.

Now let me be concrete for a moment. Commercial paper issued by a company which is held by a money market mutual fund is considered part of M_2. If that same commercial paper is held by a corporation directly, by another corporation, or by an individual, then it wouldn't be considered part of M_2. But one of the effects of this recent regulatory change I believe will be to increase the amount of commercial paper that is either held by banks or substituted for by banks for direct lending. In other words, we will see those assets move from direct holding by individuals or corporations into the banks themselves, into these money market or deposit accounts.

The result of that will be to increase M_2. I think the Fed at this point has to look at its traditional measurements, M_2 and M_1, but also look at the detail of what's happening to some of these pieces of total liquidity that may be distorting the statistics at the current time.

That's not a very short answer but there isn't a short answer to that question.

Representative **Lungren**. It seems to me what we want to do is to have economic growth without inflation, and one of the questions I guess we would ask is, Congress made a decision that through deregulation of the financial institutions that would move us more toward economic balanced growth and I guess I'm having trouble understanding whether in fact the Federal Reserve Board is making evaluations as to which the better document to use, M_1, M_2, or M_3, without regard for what these individual decisions mean in terms of whether they create economic growth.

Mr. **Feldstein**. Well, I think that their goal in effect is to achieve that rate of growth of those measures now called M_1 and M_2 that would have produced the same effects as their earlier targets indicated. M_2, if it still meant what it used to mean, would now be growing at about 9 percent, with a similarly lower rate for M_1.

The problem is that the numbers that came in are so distorted by these other things that it has to make adjustments and make corrections in order to get to that, but I think it is aiming for a rate of growth in the money stock that is consistent with the kind of gradual recovery and moderate inflation that the administration has worked at.

Mr. **Poole**. Let me talk about the importance of the deregulation issue and I want to give a bit of historical perspective.

If we start in about 1966 when regulation Q ceilings were extended to savings and loans and savings banks, we start to get in the period when the flows of funds into different kinds of accounts started to have a great deal of difficulty in interpreting the monetary numbers. Before that time, the various series, M_1, M_2, and M_3, moved so closely together that it didn't make very much difference which one you focused on. They all had very similar movements. They told the same story.

After 1966, with regulation Q ceilings on interest rates holding rates on deposits well below market rates, there were a series of innovations. There were large numbers of people in the late 1960's, for example, who started to purchase Treasury bills who had not previously held Treasury bills directly.

In the early 1970's, a clever savings bank in New England invented the NOW account which made the savings account checkable and it was a very interesting device to get around the prohibition of interest on demand deposits.

We also had about the same time the invention of the money market mutual fund. The money market fund provided services that were very similar to time deposits. In addition, these accounts were checkable, most of them, in amounts of $500 or more, and the money market mutual funds were outside the defined monetary aggregates at that time.

So we saw billions of dollars shift into these new forms and as they were shifting we were uncertain as to exactly what the significance was because these were new devices. We had no historical experience, no data, no possibility of estimating any equations to understand what was going on.

Now that process of market-induced responses to these regulations was going on in the late 1970's which proved to be a lot of difficulty in interpreting the monetary numbers.

Now we're seeing that process reversed. We have had almost complete now, for all practical purposes, deregulation of interest ceilings on deposits and now the funds are coming roaring back in, scores of billions of dollars, in a matter of weeks. I believe that this thing is going to settle down and sort itself out in a relatively short space of time. We don't know how long it's going to take, but I believe it will settle down and sort itself out and as these enormous shifts of funds cease because the market responses to the deregulated environment are complete or mostly complete, it will be possible to have a much easier reading of what's going on.

There's no question that it is difficult to read those numbers today, but it's the interaction of the old controls and then the undoing of those controls, those interest rate controls, that's causing the trouble. So I think it will sort itself out before very long.

Senator **Jepsen**. Senator Proxmire.

Senator **Proxmire**. I'd like to follow up with Mr. Poole. Mr. Poole, last year's report of the Economic Advisers denies that changes in velocity due to financial innovation should be taken into account in setting monetary targets—changes in velocity. Let me quote what you said:

> It is often stated that such financial innovations as money market funds undermine the conduct of monetary policy. Statistical support for this assertion is dubious. What would have to be demonstrated is the financial innovation has made it more difficult to achieve a given monetary target and the link between changes in nominal GNP and changes in the nominal aggregates, that is, changes in velocity, has become less predictable. The evidence does not seem to support either proposition.

Now this year's report devotes a whole page to recent changes in velocity due to recent financial innovation:

> The uncertain cause for the recent decline in velocity is characteristic of the problems the Federal Reserve has had in applying new monetary procedures that it adopted October 1979.

Now does that amount to a repudiation of the strict monetarism of last year's report as a guide to monetary policy.

Mr. POOLE. I think the right thing to say about that is to start again from the observation that in let's say 1975, 1977, 1979, one of those years, the new accounts, for example, were not even included. The money market accounts, for example, were not included in the M_2 definition of the money supply nor were the NOW accounts at that point included in the M_1 definition of the money supply.

What has happened is that as the evidence accumulated that the NOW account really belonged in M_1 and there was a lot of dispute about this—I remember living through this period and constantly asking myself, are these checking deposits or aren't they; are these really savings deposits that happen to be checkable or are they really honest to god checking deposits? Well, it took a while to sort that situation out. The same thing was true with the money market funds. Do these really belong in M_2 or don't they?

As the evidence accumulated, the Federal Reserve produced a very extensive revision of the monetary statistics and I believe that the new definitions became official in early 1980.

Senator PROXMIRE. Well, I think you're on the right track and I think it's very helpful. Let me just point out that in the last two annual reports the Joint Economic Committee Democrats have written, and I quote:

> In setting its monetary targets, the Federal Reserve should be especially alert for changes in the velocity of money. These alter the relationship between money growth and nominal GNP and so determine whether a given monetary target is restrictive or expansionary. When money velocity increases, it is appropriate to lower the target ranges in order to maintain an equivalent degree of constraint and, conversely when money velocity falls.

Do you aree with that statement?

Mr. POOLE. I will agree with it if you will allow me to give a qualification.

Senator PROXMIRE. I wouldn't expect you to not give a qualification.

Mr. POOLE. It is well known, and this would be true of economists of both persuasions, that the impact of monetary changes in the economy occur with a lag. That is to say that when we have a change in money growth that we do not expect to see the effects on outputs and inflation occur right away. Therefore, when we talk about velocity which as typically measured makes no allowance for these lags, we have no way of knowing for sure when we see a change in velocity whether it is occurring as a result of some fundamental change in the behavior with respect to holding assets or whether it's a process of working out the lags that we do not have a really good handle on.

So it seems to me that what we want to say is that over time we may well accumulate evidence which suggests that there's been a change in the trend of velocity.

Senator PROXMIRE. I think that's very satisfactory. Let me ask you, Chairman Feldstein, what growth rate and credit do you estimate to be consistent with your economic forecast for 1983, M_1 and M_2?

Mr. FELDSTEIN. I would say somewhere in the 7- to 9-percent range for M_2 and about 3 percent less than that for M_1, but for the measurement problems we've been talking about. In reality, I think we're going to see much larger rates of growth of M_2. I'm not sure what's going to happen to M_1, but we are likely to see much larger rates of growth of M_2 that really reflect a shift in the way people want to hold assets.

Senator PROXMIRE. And what level of interest rates would you say are consistent with that forecast?

Mr. FELDSTEIN. That is much tougher to say. I think that what we all hope is that expectations of declining inflation firm up so that long-term rates come down, but I don't know how to put a number on that.

Senator PROXMIRE. Let me ask you just one final question. I appreciate your position on defense spending and I think we all have to spend whatever is necessary to defend this country and make our best judgment on it. I happen to be critical of the aircraft carriers, the MX, the B-1 and so forth, but beyond that, there's evidence that rapid rises in defense spending are inefficient if they are too rapid and invariably they are accompanied by waste, unnecessary cost, credits, especially in procurement, and most of the rise in the Reagan military buildup is procurement and we would expect therefore procurement costs are excessive and getting further out of control. I believe that's the conclusion of several recent studies, including one done by Frank Spinney in the Pentagon, another by the Heritage Foundation.

So doesn't that suggest that perhaps the pace of the buildup, aside from our judgment on weapons systems—the pace may be too rapid and should be slowed down?

Mr. FELDSTEIN. We are currently in a situation where there is tremendous slack, so when you talk about buildup of aircraft production we are doing that in the context of where the domestic civilian aircraft industry is way down.

Senator PROXMIRE. Not just slack. Doesn't it have to do with management too? Isn't it very difficult?

Mr. FELDSTEIN. The civilian aircraft industry is capable of producing at a much higher rate than it is now. So they can shift over their production to military aircraft in a way that's much easier than if we were trying to do this in an economy that was booming.

Senator PROXMIRE. Why do costs keep rising then?

Mr. FELDSTEIN. There's no question that there is additional strain in any market if you try to increase output more rapidly, but costs are rising throughout the economy at the current time. There is inflation in general. I can't really answer the specific question on the defense sector.

Senator JEPSEN. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, first I'd like to include in the record the Washington Post/ABC news poll that Senator Proxmire made reference to earlier, with the full questions and responses.

[The news poll follows:]

[From the Washington Post, Feb. 1, 1983]

THE FEDERAL BUDGET, FISCAL 1984—REAGANOMICS SUPPORT ERODING: POLL SHOWS RISING OPPOSITION TO BUDGET PROPOSALS

(By Barry Sussman)

Public support for the Reagan economic program, regarded as a major factor in congressional implementation of most of the president's budget requests in 1981 and 1982, has largely evaporated, according to the findings of a Washington Post-ABC News poll.

In sharp contrast to those years, most citizens now oppose key aspects of Reagan's budget proposals.

A majority of the public, for example is ready to forgo the 10 percent cut in marginal income tax rates scheduled for July, although Reagan says he is adamant in his refusal to delay or eliminate that reduction. A majority also favors cutting military spending but not social programs, to reduce the national debt.

And a majority favors establishing a jobs program even if that increases the deficit. On each issue, the majority view is in direct opposition to the Reagan administration proposals.

Politically, one result of this massive shift in the national mood will be to make it easier for members of Congress to oppose the president. Repeatedly during Reagan's first two years, moderate Republicans and many Democrats either voted for his proposals or failed to fight them forcefully, saying they had to bow to the president's "mandate" from the public.

Some of the findings from the Post-ABC News poll, in which 1,510 people were interviewed by telephone from Jan. 18 to Jan. 23:

By 55 to 39 percent, a majority favors reducing the budget deficit by canceling the 10 percent income tax cut set for July 1. By 63 to 32 percent, the public rejects Reagan's contention that the tax cut will help improve the economy and create new jobs. At the same time, however, the public opposes by 2 to 1 any tax increase to reduce the deficit.

A majority of 59 to 37 percent favors cutting military spending to reduce the deficit, with 4 percent expressing no opinion. In contrast, when Reagan's budget was before Congress last February, a Post-ABC News poll found cuts in military spending opposed by 53 to 41 percent.

By 52 to 44 percent, the public opposes cutting spending on social programs to reduce the debt, despite being told by Post-ABC News interviewers that "financial experts say the next government budget will have the largest deficit in history." A similar majority opposed cuts in social programs last year, after supporting them in 1981.

By 51 to 42 percent, according to the poll, citizens support government "spending to create new jobs, even if that means higher budget deficits."

THE WASHINGTON POST/ABC NEWS POLL—REPUBLICANS, DEMOCRATS DISAGREE ON CUTTING SOCIAL PROGRAMS BUT FAVOR MILITARY SPENDING CUTS, CANCELING TAX DECREASE

[In percent]

	All Interviewed		Republicans		Democrats	
	For	Against	For	Against	For	Against
Do you think the Government should cut spending for social programs to reduce the budget deficit, or not?	44	52	62	34	35	61
Do you think the Government should cut military spending to reduce the budget deficit, or not?	59	37	52	44	62	34
As you may know, a 10-percent Federal income tax cut is scheduled to go into effect this summer. Do you think that tax cut should be cancelled to help reduce the Federal budget deficit or not?	55	39	56	37	56	38

Note: From a nationwide Washington Post-ABC News telephone poll of 1,510 people, Jan. 18–23. Figures do not add to 100 percent because "no opinion" responses have been omitted.

Senator Sarbanes. Second, Chairman Feldstein, I notice the President in his state of the Union message, when he used these percentages of GNP, used 1970 as his reference point. Of course, in 1970 the unemployment rate was 4.9 percent, in other words the economy was working at full employment, and you compare that with a percentage of GNP in a depressed economy with unemployment over 10 percent, between 10 and 11 percent.

I don't want a response. I just want to make this point. First of all, you have to judge defense needs, social needs, and taxing policy in and of themselves, it seems to me; and second, to compare shares of the GNP in two entirely different kinds of economies, one at full employment and the other in a deep trough, is comparing apples and oranges. If we were down to 5 percent unemployment now, the GNP would be up about what, $250 billion?

Mr. Feldstein. No. It would be up about $150 billion.

Senator Sarbanes. At 4.9 percent?

Mr. Feldstein. About $25 billion per percentage point of unemployment. You said 5 percent.

Senator Sarbanes. 4.9 percent unemployment.

Mr. Feldstein. I'm sorry. What was the number?

Senator Sarbanes. I'm using the 1970 number, the year to which you made reference in using these percentage shares—or the President made reference, to 4.9 percent.

Mr. Niskanen. Senator Sarbanes, rather by accident, the years 1960, 1970, and 1980 were all years of mild recession, so those years are roughly comparable years in terms of the state of the economy at that time. The unemployment rates differ across those years because the unemployment rate at cyclical troughs and cyclical peaks have progressively increased over that period of time. But in terms of the general state of the economy, the economy was in much the same condition in 1960, 1970, and 1980.

Senator Sarbanes. To what year was the President's reference in the state of the Union address in speaking of percentage of GNP? It was 1970, isn't that correct?

Mr. Niskanen. That's correct.

Senator Sarbanes. Would you regard today as roughly comparable to 1970, in terms of the state of the economy?

Mr. Niskanen. We have recently completed I believe the longest recession of the postwar years; 1980 I believe is quite comparable.

Senator Sarbanes. You've got to be kidding. How can you talk about shares of the GNP and use 1 year at 4.9 percent unemployment and another year at 10.5 percent unemployment, with the loss in GNP that the 10.5 percent represents and contend that those shares of GNP are somehow comparable to one another?

Mr. Niskanen. Senator Sarbanes, I don't recall specifically what the President said in the state of the Union address on that matter. I think it is appropriate to compare 1970 with 1980.

Senator Sarbanes. But that's not the point I'm making.

Mr. Niskanen. Whether it's comparable to 1982 is another matter.

Senator Sarbanes. Well, I appreciate that.

Now the next question I want to ask you, Chairman Feldstein, do you think we should pass legislation providing Federal assistance for the soup kitchens across the country?

Mr. Feldstein. Let me first say that I didn't understand the question you asked before. When I said $25 billion, that was the impact on the deficit. If we were now at about 6 to 7 percent unemployment we would have GNP——

Seantor Sarbanes. 4.9 percent.

Mr. Feldstein. If we were at 4.9 percent, we would have—well, $300 billion would be a reasonable number.

Senator Sarbanes. All right. Thank you.

Mr. Feldstein. On that point, let me say that that would mean that the GNP was about 10 percent higher and therefore you could correct all the percentages that we have been talking about now. It would mean that defense spending in 1983, instead of being 6.9 percent of GNP, the current level would correspond to about 6 percent of GNP. So I don't understand what the point would be since that would mean that the defense since 1970 and the share of GNP going on defense would be even greater.

Senator Sarbanes. How about taxes?

Mr. Feldstein. Taxes between 1970 and 1983 fell roughly 20 to 19. It would go from 20 to 17.

Senator Sarbanes. That's right. The taxes would go from 20 to 17?

Mr. Feldstein. Roughly speaking, very rough, 20 to 17, nondefense, noninterest——

Senator Sarbanes. What about the soup kitchens?

Mr. Feldstein. OK. Back to the soup kitchens. I don't know enough about the way in which the Federal Government might help, but I certainly think it's something we should look into.

Senator Sarbanes. Do you think the Federal Government should provide assistance for emergency housing for the homeless?

Mr. Feldstein. I really don't want to answer questions without having a more specific program in mind.

Senator Sarbanes. Do you think the Federal Government should take steps to put some restraint on the farm foreclosures now taking place across the country?

Mr. Feldstein. Let me say that of this list, I wouldn't rule out any of them. I would want to think about all of them.

Senator Sarbanes. How about home mortgage foreclosures?

Mr. Feldstein. Well, there are obviously pluses and minuses.

Senator Sarbanes. What are the minuses? That they cost money?

Mr. Feldstein. No. The minuses are if you say to some people that if they don't make their mortgage payment you won't foreclose, then it's an invitation to everybody to do that. It's an invitation to the bankers to stop lending and for housing construction to stop happening.

Senator Sarbanes. What about the soup kitchens and the homeless? Is the money the problem here?

Mr. Feldstein. It depends on the amount you spend, but I would say that's something we should——

Senator Sarbanes. Why should a higher priority be placed on a further tax cut to the very wealthy, at the upper end of the income scale, rather than on addressing the problem of the soup kitchens and the homeless and foreclosures?

Mr. Feldstein. The foreclosures I've spoken to. On the other thing, I think it's an issue worth looking at. Whether it's appropriate for us to do that on a targeted program or whether it's better for it to happen through the State and local governments, whether it would be better for us to include that within the scope of block grant programs, that's the kind of questions I would have.

Senator SARBANES. Let me bring it closer to home. What's the increase in the budget of the Council of Economic Advisers for fiscal 1984 over the current year?

Mr. FELDSTEIN. In the way they describe budgets in this town, I think it is 0.0000003.

Senator SARBANES. The budget book seems to state that you're asking for a 13.6-percent increase.

Mr. FELDSTEIN. I think that is as many zeros as I said followed by a 3. I was trying to put it in dollars, but we have a budget of about $2 million, so the increase is about $260,000.

Senator SARBANES. 13.6 percent?

Mr. FELDSTEIN. That's right.

Senator SARBANES. What's this 0.00000 stuff?

Mr. FELDSTEIN. I was just giving it to you as billions of dollars. If you take $300,000 and——

Senator SARBANES. Your budget is going up 13.6 percent, isn't it?

Mr. FELDSTEIN. I believe so.

Senator SARBANES. Now where is the freeze that we've heard so much about?

Mr. FELDSTEIN. The total domestic spending, including my budget, including other agencies, some of which have been eliminated by the administration, would be frozen between 1983 and 1984.

Senator SARBANES. How do you justify the budget of the CEA going up 13.6 percent in the context of this budget?

Mr. FELDSTEIN. I think the economic problems are getting bigger and bigger.

Senator SARBANES. Is your budget increase larger than that of the Pentagon percentagewise?

Mr. FELDSTEIN. I'll tell you in a minute. If your numbers are right about our budget, the Pentagon number is 14 percent.

Senator SARBANES. Here's the budget book, if you disagree with it. You're going from $2.172 million, estimated for 1983 to $2.469, estimated for 1984. Is that correct? That's 13.6 percent. What's the Pentagon going up?

Mr. FELDSTEIN. Fourteen.

Senator SARBANES. You didn't quite make it?

Mr. FELDSTEIN. Right.

Senator SARBANES. What's the justification for that increase in this context?

Mr. FELDSTEIN. I think that the resources, to be very serious now and not joke about it in terms of billions of dollars, but I think the resources——

Senator SARBANES. I'm not joking about it either, because there is a problem here of equity. You're laying this off on everybody else as part of your major economic recommendations. You have been in here today pressing for further cuts in the domestic side—that's the standard litany we receive—but when we look at your budget to see what's being done in your own shop, which I did as a matter of curiosity, we find something quite different. I assumed I was going to find a cut, or certainly not an increase, and here I discover that it almost equals the Pentagon at 13.6 percent.

Mr. FELDSTEIN. It's a little smaller in absolute size. I think that the problem we face as a nation and the problem the President faces in the economic area make it easy to justify spending $2.5 million a year on doing all of the economic analyses for the President.

Senator SARBANES. That's not the question. The question is how you justify getting a 13.6 percent increase over last year? If you came in with $2.712, I'd have said, well, you froze your own office so you're playing by the ground rules that you're handing out to everybody else. But you're not doing that. You're like every person making economic policy in this administration who's telling the people they have to go through the wringer and is appealing to their sense of sacrifice; they're told they've got to sacrifice and go through the wringer for the good of the country, but it turns out that the people telling them they have to go through the wringer aren't going through the wringer themselves. It's reflected in your budget and for the country in how economic policy affects the individuals who are making it. The millionaires making this economic policy are reaping tremendous benefits through the tax cuts that you insist on holding onto, all the time throwing the burden on middle income and working people in this country.

Mr. FELDSTEIN. Maybe we could talk about the tax cuts for a minute. I think the one thing that can be said——

Senator SARBANES. I still haven't gotten an answer on your budget, the CEA budget.

Mr. FELDSTEIN. Let me come back to the budget then. Unlike the other domestic programs that I've been pointing to that have grown so dramatically over the years, the CEA size now, the real physical size, number of economists available on our staff, is substantially lower than it was when some of my distinguished predecessors like Art Okum held this job. We will be in 1984 significantly below that level of staffing. We are building up a bit because the President feels—and I hope that you all feel—that providing more economic analysis is helpful to making good economic policy.

Senator SARBANES. Thank you, Mr. Chairman.

Senator JEPSEN. Well, with that blaze of glory we'll end this meeting and, Mr. Feldstein, Mr. Poole, and Mr. Niskanen, on behalf of the committee. I thank you for your candid responses and the effort and work in the preparation that you made to appear before this committee. It's not always that we enjoy responses where the answers are as forthcoming as quickly and directly as we've had from you gentlemen today. I appreciate that.

The committee will stand in recess until 2 o'clock this afternoon.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. I'd like to welcome our witness today. Office of Management and Budget Director, David Stockman. Under his leadership, OMB has been a strong and effective advocate of budgetary restraint. I am sure Mr. Stockman's testimony today will help put the current budget debate in perspective.

Since 1965, the share and amount of domestic spending has expanded dramatically. This mounting burden on saving, investment, and consumption is a major factor limiting our economic growth. Federal spending must be brought under control. Open-ended commitments by the Federal Government must be contained. About three-quarters of the budget now is exempt from annual review and adjustments by Congress. This is still no reason for not bringing it under control. Through legislation Congress created most of those programs, and it can also change them. I've said many times, Mr. Director, that it's not the budget that's out of control in Washington; it's the people that make the budget that have been out of control over the years.

The President's $848 billion fiscal 1984 budget contains many good proposals to help restore fiscal moderation. At the same time, however, there are a number of suggestions that I'm not so sure about. The contingency tax proposal, for example, seems unnecessary and could well be counterproductive if it encourages efforts to substantially increase taxes. Furthermore, many of the spending items will be altered by Congress.

Last year in your statement before this committee you said that the fiscal 1983 budget was the "most difficult set of budget options ever presented to the Congress." In reviewing the fiscal 1984 budget proposal, I think the choices presented are just as difficult as those of last year, and in some ways perhaps more difficult. But I believe that our fiscal problems, however large, can be dealt with effectively if we address them in an analytical and factual manner. Above all, we must avoid emotionalism and partisanship if we are to improve the situation.

We certainly want to avoid making the budget problem worse and we also want a sustained economic recovery.

Congresswoman Holt, do you have any opening statement?

Representative HOLT. No, Mr. Chairman.

Senator JEPSEN. Congressman Scheuer, do you have any opening statement?

Representative SCHEUER. No statement, Mr. Chairman, except to welcome our former colleague, Mr. Stockman.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. No, Mr. Chairman.

Senator JEPSEN. Congressman Wylie is unable to attend today's hearing and has requested that his opening statement be made a part of the printed record, without objection.

[The opening statement of Representative Wylie follows:]

OPENING STATEMENT OF REPRESENTATIVE WYLIE

I would like to join in welcoming OMB Director David Stockman this afternoon. He has one of the toughest jobs in Washington—trying to restrain Federal spending. The success achieved to date is largely due to his efforts.

I applaud the leadership of the President for proposing a freeze on a substantial portion of the budget. This is probably the only politically acceptable way of restraining spending. My only reservation is that the freeze concept may not have been applied broadly enough to win congressional approval. No area of the budget should be exempt from careful review. However, we must conduct our budget review with keen sensitivity toward those in distress through no fault of their own. The social safety net should be maintained. Happily, the economic recovery appears to be underway, bringing better times for our people and lessening pressures on the budget.

Though last year's budget fight was messy and acrimonious, this year may be even worse. In spite of the fact the next election is almost 2 years away, the budget debate this year already is starting on a highly charged partisan note. Charges and countercharges fill the air. I, for one, hope that the Congressional budget process can survive the pressure that will be placed on it this year. The problems of increased spending and deficits aren't going to fade away, but will require action by the Congress. I share the wish that the budget debate be conducted in a climate of facts and dispassionate analysis.

Senator JEPSEN. Mr. Director, welcome, and you may proceed.

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Well, thank you very much, Mr. Chairman. I'm delighted to be before your committee again and I note that the four soundest thinking members of the committee are here, so I'm tempted to dispense with my statement and get your questions quickly before anybody else comes, but if you would agree, I will insert in the record the entire document that we have distributed to you.

This is an effort through a series of charts and some descriptive material to show what's in the budget; the context in which we're working; the size of the problem; and some of the impacts that would result if all of the recommendations in the budget are followed.

I obviously won't take the time of the committee to go through all of that, but I do have about 5 minutes worth of comments to summarize this whole picture as we see it in the administration. I would like to pass them on to the committee.

If I were to describe this budget, Mr. Chairman, I would say that the budget is realistic; it's fair; and it's based on the tough medicine which will be required to get the deficit down and thereby insure that the recovery gathers momentum, that people are put back to work, and that noninflationary growth can be sustained not only next year and the year after but into the more distant future.

After all, everything that we want to accomplish as a nation—whether it's meeting our unfilled domestic needs, providing for our national security, improving the standard of living of the American people or providing new opportunities for those who have been outside the mainstream thus far—requires sustained economic growth over time. My point before this committee today and every other committee of the Congress is that unless we can reduce these enormous deficits that have been built into the budget as a result of events last year, the previous year and indeed over a decade, we're not going to get that kind of growth and we're going to be frustrated on every front in terms of meeting our national objectives.

Let me say to the committee today that this budget rests on a few basic premises. Let me outline them.

The first one is that in 1983 the Federal Government will spend the staggering sum of one-half trillion dollars—$500 billion—for domestic programs excluding net interest. These programs range all the way from the FBI to the social security system, from low-income home energy assistance to farm price supports. And when you consider the magnitude of that one-half a trillion dollar expenditure pouring out of the budget this year right now against the size of the built-in deficits that we're looking at, it's very clear to me that we must draw the line. We must draw the line now and find a way to live in 1984 with one-half a trillion dollars devoted to domestic needs and programs of this country. This is a way of saying, "Let's freeze the nondefense budget at exactly the level overall that it will be this year, $501 billion."

Now to achieve that we can't simply freeze the number. We have to look at a whole variety, an array of different kinds of programs in the budget and decide what kind of freeze mechanisms are applicable, workable, and fair. And we believe that this budget has done that. We have proposed to freeze COLA's not only in social security but in related benefit programs for 6 months, as the National Commission on Social Security Reform has recommended.

We have proposed to do what literally thousands of employers around this country have had to do during these very difficult times and that is to grant no pay increase to the military and civilian employees of the Government or retired employees of the Government over the coming year. That is always difficult to do but if there were ever a time that it was justified it seems to me that it is justified now when the inflation rate has fallen to 3.9 percent on a December over December basis and we're facing the magnitude of fiscal imbalance and the amount of red ink that we project without these kinds of measures.

We're proposing that in other areas of the budget where a freeze concept makes sense that it be applied in an evenhanded way. We have proposed a freeze for physician reimbursement and hospital reimbursement under the medicare and medicaid programs. We have proposed to freeze target prices in the farm price support program for the various commodities that are automatically escalated under current law. For the discretionary programs that I know this committee and others in the Congress are concerned about, we have proposed to implement the mandate that was in the 1983 budget resolution to keep aggregate discretionary spending flat for 1984 over 1983.

Now I think these measures will be difficult; they will cause dissatisfaction; nevertheless, they are justified. To begin with, over the last 4 years COLA's have increased about 50 percent; the average wage in the private economy has increased 38 percent, not nearly as rapidly. In order to get this recovery going and this budget under control, it seems to me that a temporary delay, a temporary freeze in light of that 4-year backdrop is appropriate and justified and has been agreed to already at the top leadership level on a bipartisan basis.

If we extend that principle to all the other items and program mechanisms in the budget that I have mentioned, we will save $19 billion in 1984 and $164 billion over the next 5 years.

Mr. Chairman, it is obvious that the freeze is unavoidable, it's necessary, and we will have much detailed argument about how, where precisely, and in what manner to apply it, but it needs to be done for 1984. That will not solve the problem in itself in the long run, but it's a place to start. It's a way of containing the deficit. It's a way of starting with the $209 billion in red ink that we'll face this year and reversing the trend so that it heads down to a much smaller share of GNP rather than the high share that we project under the current services baseline if we didn't implement these measures.

Nevertheless, for the outyears and for the longer run we have to address one of the fundamental mechanisms in the Federal budget that continues to cause spending to rise at excessive rates. I refer to the big pension and medical entitlement programs that in 1984 will cost $329 billion under current law, more than $87 billion higher than their funding levels just 3 years ago in 1981. That would continue to climb at double-digit rates until they cost $456 billion by 1988 or $214 billion more than we spent on the medical and retirement programs as recently as 1981.

We have proposed in this budget a series of measures that we call structural reform designed to slow down the growth momentum that we've seen in the past and that's built into the future in these major programs.

The first element is the bipartisan social security solvency plan that the Speaker has endorsed and the President has endorsed. That will reduce the deficit by $79 billion over the next 5 years even as it restores solvency to social security. It insures that after July 1 the benefits and the support that 36 million American people need and expect will indeed be paid.

The second element is a major program to begin to contain the spiraling cost of health care in our private and public health care delivery and financing programs. I would point out to this committee that in the last 8 years the combined cost of medicare and medicaid has risen from $20 billion in fiscal year 1975 to $72 billion this year, a tripling in 8 fiscal years, far more than the rate of inflation—in fact, five times greater.

If we do nothing, these programs will cost $133 billion a year by 1988, the last or fifth year out in this budget.

Well, obviously there are roughly 42 million Americans who depend on medicaid and medicare for their basic medical services. That protection and those services must be continued. I believe, and I hope the members of this committee will also believe, that we can find a way of providing those benefits and of funding that entitlement without spending $534 billion on medicare and medicaid over the next 5 years because that's what's programed into current law, one-half a trillion dollar expenditure just for those programs.

But we believe you can't solve the problem by changing medicare and medicaid alone. You have to get to the heart of it, which is in the pervasive system of third party payments throughout our private and public financing and delivery system. Therefore, we propose to put a cap on the tax exclusion for private health benefits at $175 a month in order to discourage the excessive first dollar coverage that we have today. This will begin to induce into the health care system some greater sense of cost consciousness both on the provider's side and on the side of those who consume health care services.

The reform of the private health insurance system and the changes that we're proposing in medicare and medicaid that will pay providers in a way that is efficient and that will ask beneficiaries to participate in copayments in order to reduce excessive utilization of services and length of stay, could save about $58 billion over the next 5 years and reduce the deficit accordingly.

We've also proposed other changes. I won't detail them all here today for the committee, but the one that I think is most important is getting the civil service retirement system under control and solvent or we will soon face the same problem there that we're now struggling with on social security. That system is already unfunded to the tune of one-half of a trillion dollars. It costs 35 percent of payroll to fund the annuities built into current law. That is not sustainable over time and we are proposing to institute a series of reforms phased in over 10 years that would eventually reduce the cost of that system to 22 percent of payroll, still generous by any comparative standards in private or public sector elsewhere. The proposal will increase the employee contribution from 7 to 11 percent over 2 years so that employees would fund half of their retirement annuity, as private employees do today under the social security system.

These are just a few of the major long-term structural reforms that we're proposing in order to bring this huge cost of transfer payments somewhat under control for the future and help reduce the deficit threat that we face.

But let me say the third premise is that the budget cannot be solved without cooperation, cooperation between the executive branch and the legislative branch, and cooperation between the parties and the Houses. Therefore we've attempted to recognize and to acknowledge in this budget some of the things that we have learned over the past 2 years, as we've struggled through two very difficult budget cycles, about congressional priorities and about congressional sense for where funds are needed and where changes should and should not be made in the structure of the budget.

So for that reason, in the discretionary area, we have proposed no reduction in the aggregate from the level that Congress funded in 1983. In the main, programs are funded at nearly the exact level that Congress provided in 1983. I use handicapped education as one example. The women, infants, and children feeding program is another example, and obviously there are hundreds more throughout the budget.

But in some cases we felt that priorities warranted increases and so the budget reflects an 18-percent increase for the National Science Foundation, 15 percent for Head Start, 11 percent for foster care and child welfare services. But in order to stay within a fixed envelope of funding for discretionary programs at the 1983 congressional level, it was necessary to pay for these increases with reductions elsewhere in programs that we concluded to be of lower priority.

So we've cut the postal subsidy by about $400 million because we believe that's a cost that ought to be borne primarily by those who benefit. We've cut out some of the unnecessary funding for energy R&D because given the magnitude of fiscal problems we face those projects do not seem worthwhile. We cut funding for Army Corps of Engineers construction by several hundred million dollars, again, not because it's inherently bad but because in order to live within a fixed envelope of $113 billion, a freeze on discretionary programs in the aggregate, we had to find places to save money in order to fund the increases that are needed.

But I think overall, if you look at the chart on page 18, you will see in a very clear way the point I'm trying to make in terms of recognizing congressional priorities on some of the smaller items in the budget. This is to foster cooperation among us as we attempt to grapple with this huge problem and these very difficult changes in the revenue area and in the entitlement and COLA area that I've just mentioned.

The programs listed in the box on page 18 are programs that we've felt in the past should be reduced for a variety of reasons. In some cases because they're not effective, in others because they are primarily State and local responsibility.

Last year we asked for $11 billion for these programs but Congress decided to fund them at a level of nearly $16 billion—handicapped education, impact aid, child welfare, foster care services, and so forth. This year we've asked for $16 billion, $5 billion more than last year, out of recognition that after two budgets the Congress has pretty thoroughly indicated where it would like to see these programs funded. I think it would detract from the process to contend and struggle over these items when we should be focusing our collective attention on these larger elements in the budget that need to be changed.

Mr. Chairman, the fourth premise is that if the deficits in the outyears do not steadily decline relative to the economy and relative to the pool of private savings that we project to be available, then there is simply no way that recovery can be sustained. Sustained recovery requires new investment, new technology, and new factories. If the Federal Government is absorbing 80 or 90 percent of the savings available, then new investment will not occur and growth will not be sustained.

So we have proposed a deficit insurance policy in the form of a standby revenue measure or mechanism that would automatically trigger in and generate some $150 billion in revenue over the 1986–88 period, the last 3 years in this budget, if the deficit is above 2.5 percent of GNP; that is, if the deficit is so high it threatens the sustainability of the recovery.

The final point I would make before going to your questions is to point out that I'm afraid we will have a contentious and argumentative struggle on the question of defense spending. Even as that occurs, because there are legitimate grounds for disagreement on this or that system or on precisely the amount of dollar increase needed, I hope that we will recognize that the differences between us are far less than they would appear, given the extremity of the rhetoric that we have been hearing, unfortunately, in the last few days.

The thing that we need to remember is that a budget does not have a life of just 1 year. It has to be seen in terms of the flow of time and the shift in priorities and the change of resources over 2 or 5 or 10 years. If we put this budget in that context and recognize what we have already done over the last 3 years, I believe that we can help put this debate in perspective and therefore prevent it from becoming a roadblock to the kinds of sweeping budgetary solutions we need.

What I mean specifically is that in 1981 all of us—both sides of the aisle, conservatives and liberals alike—said that we had allowed defense funding to decline so seriously in real terms after inflation over the latter years of the 1970's that in every category of military strength we were in a deplorable state in terms of the future security of this country.

Pay was way too low. We couldn't recruit and retain people. Readiness was abysmal on almost any measure that you want to use. Strategic modernization was critical and imperative and yet we had no major initiatives underway. For the entire decade there had been very little modernization of our basic conventional weapons systems. So there was an overwhelming consensus that increases were needed, that a get-well program was necessary, and that it would cost substantial money over a sustained period of time.

So Congress agreed to a $7 billion supplemental that we requested in 1981. Then in 1982, after some discussion and some debate, Congress agreed with large majorities, both Houses and both sides of the aisle, to a $35 billion increase to fund the get well program, the readiness and modernization and pay.

And last year, after the $7 billion in 1981 and the $35 billion in 1982, there was a considerable debate but when the smoke cleared and the final bill was passed, $25 billion in addition was provided to maintain these initiatives that were underway.

Now Congress has agreed to this and the country has supported it. The thing to remember is that the increase in this budget for 1984 essentially reflects the money needed to fund the initiatives that were started and supported over the last 3 years. When we fund readiness at a higher level, that increases the base and it has to be continued if we want training and other areas to be maintained at a high level.

When we start various modernization programs for weapons systems, the money has to continue to flow in if we're to actually complete those systems and get them on-line as we planned.

So my point here is that we may have a big argument this year about whether $35 billion is the right number, but given what we've started and given what we've felt was necessary, there can be no radical change in that number. There should be no suggestion that the whole deficit problem is due to the defense request for 1984 because it is not and we clearly understood that in the past.

The other point that I would make is that I have heard the argument a number of times now that defense spending is up in real terms after inflation at 10 percent in this request and domestic spending is down by 3 percent in real terms and that's unfair and that's unbalanced, and that is no way to make a budget. I would suggest that is no way to make a comparison either. We can't simply look at change from 1 year to the next.

I would point out that if you went back to 1970 and you compared our request for 1984 with what this country spent for defense in 1970 and you strip out the inflation so you make a constant or real dollar comparison, the request in this budget for defense spending in 1984 is only 8 percent more in real terms than what we spent in 1970. By contrast, on the nondefense side, even with the cuts that have been pointed out in some of the complaints and criticisms that have been made, the half trillion dollars in this budget request for 1984 represents an 88-percent increase in constant dollars over what we spent for domestic purposes, from transfer payments all the way to the old-line Federal agencies, in 1970.

Now it seems to me that if we found it necessary and possible to increase spending for domestic purposes by 88 percent over 14 years to further or provide for the welfare and the domestic security of this country, then in some basic scale of things it is not unreasonable to think that we might need a 5-percent increase over that same 14-year period to assure the national security of this country as well.

Although we can argue about the details, I think the suggestion that somehow this budget is upside-down in terms of priorities or that this deficit is attributable to the request in 1984 for defense is drastically and utterly wrong and needs to be eliminated from the debate. It is a debate we will have, but within a channel of reason and within a context that understands what we need to do and looks at this in a little more perspective than we're getting right now.

So those complete the basic comments that I wanted to make about the budget, Mr. Chairman, and I'd be very happy to take your questions and the questions of others on the committee.

[The charts referred to by Mr. Stockman follow:]

PART I — BUDGET TOTALS — PRESIDENT'S BUDGET FREEZE AND REFORM PLAN

BUDGET TOTALS AT A GLANCE

	1983	1984	1985	1986	1987	1988
OUTLAYS . . .	805	848	919	990	1,058	1,127
RECEIPTS . . .	597	660	724	842	916	1,010
DEFICIT	208	189	194	148	142	117

HIGHLIGHTS

- PRESIDENT'S BUDGET FREEZE AND REFORM PLAN RESULTS IN NO REAL GROWTH IN 1984 BUDGET
- REDUCES DEFICIT BY $43 BILLION IN 1984 AND $558 BILLION OVER 1984-88
- MAINTAINS ESSENTIAL DEFENSE BUILD-UP AT $55 BILLION LOWER 5-YEAR COST
- CAUSES DEFICIT SHARE OF GNP TO STEADILY DROP—KEEPING BUDGET ON A PATH CONSISTENT WITH SUSTAINED ECONOMIC RECOVERY

1983	1985	1988
6.5%	5.1%	2.4%

FOUR-POINT BUDGET FREEZE AND REFORM PLAN

1) 1984 Spending Freeze Measures

- No increase in civilian/military pay and retirement.
- 6-month COLA freeze for Social Security and related indexed benefits.
- Freeze on aggregate non-defense discretionary programs, medical provider reimbursement and farm price supports.

2) Long-term Structural Reform

- Bipartisan Social Security Solvency Plan which cuts $79 billion from 1984-88 budget deficit.
- Health care reform and efficiency incentive package involving $58 billion in 5-year savings from Medicare/Medicaid and private health insurance cap.
- Major reforms of civil service retirement, better targeting of means-tested entitlements and veterans benefits.

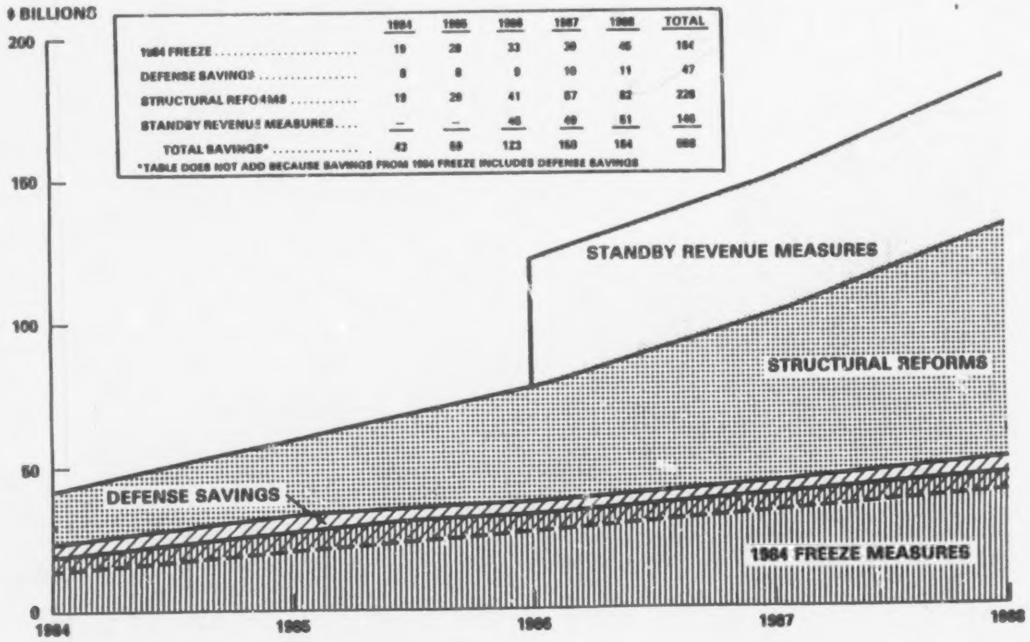
3) Maintenance of Defense Build-up at Lower Cost

- $55 billion in pay, fuel and inflation and program economies and savings over 5 years.
- Fully protects strategic programs, readiness and sustainability initiatives and conventional forces modernization.

4) Deficit Insurance Policy

- Standby tax equal to 1% of corporate and individual taxable income and $5 per barrel oil excise tax.
- Triggered in FY 1986-88 only if budget freeze and spending reforms adopted, deficit above 2.5% of GNP, and economy in recovery.

FOUR-POINT BUDGET FREEZE AND REFORM PLAN AT A GLANCE

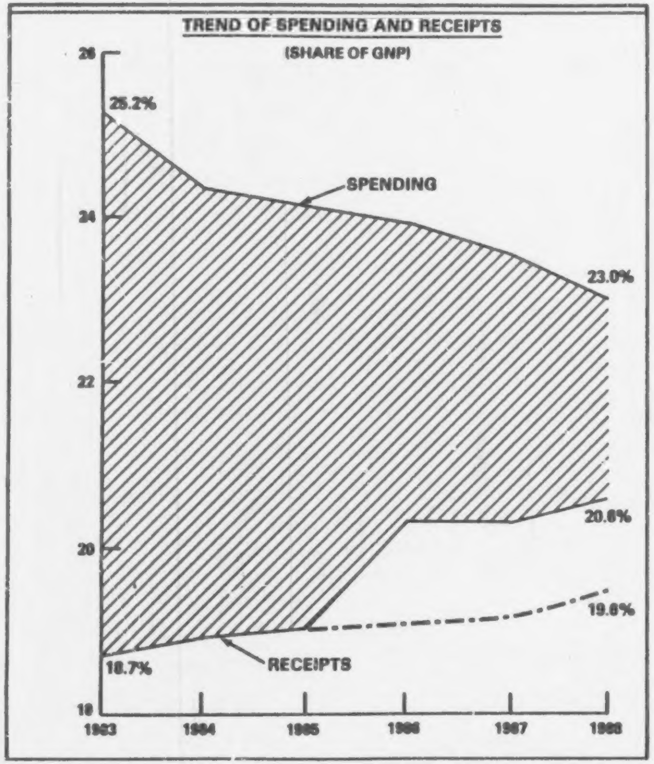


	1984	1985	1986	1987	1988	TOTAL
1984 FREEZE	19	28	33	39	45	164
DEFENSE SAVINGS	8	8	9	10	11	47
STRUCTURAL REFORMS	19	29	41	57	82	228
STANDBY REVENUE MEASURES	—	—	46	49	51	146
TOTAL SAVINGS*	43	58	123	150	184	558

*TABLE DOES NOT ADD BECAUSE SAVINGS FROM 1984 FREEZE INCLUDES DEFENSE SAVINGS

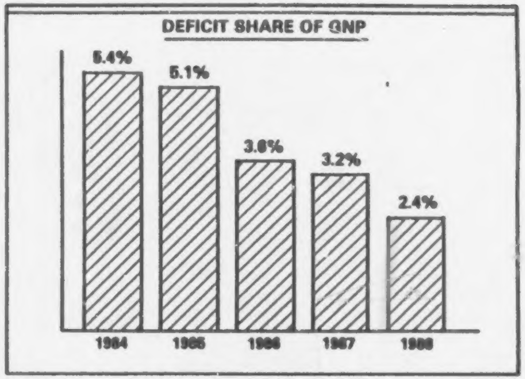
FISCAL ECONOMIC IMPACT AT A GLANCE

(SHARES OF GNP)

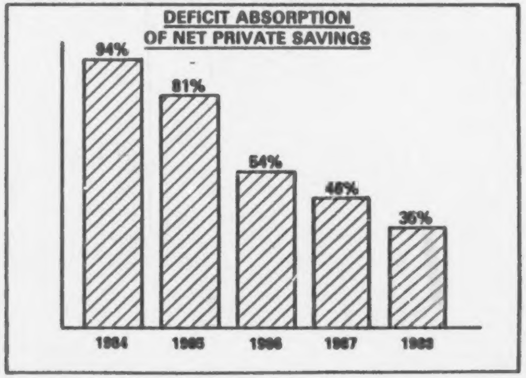


TREND OF SPENDING AND RECEIPTS

(SHARE OF GNP)

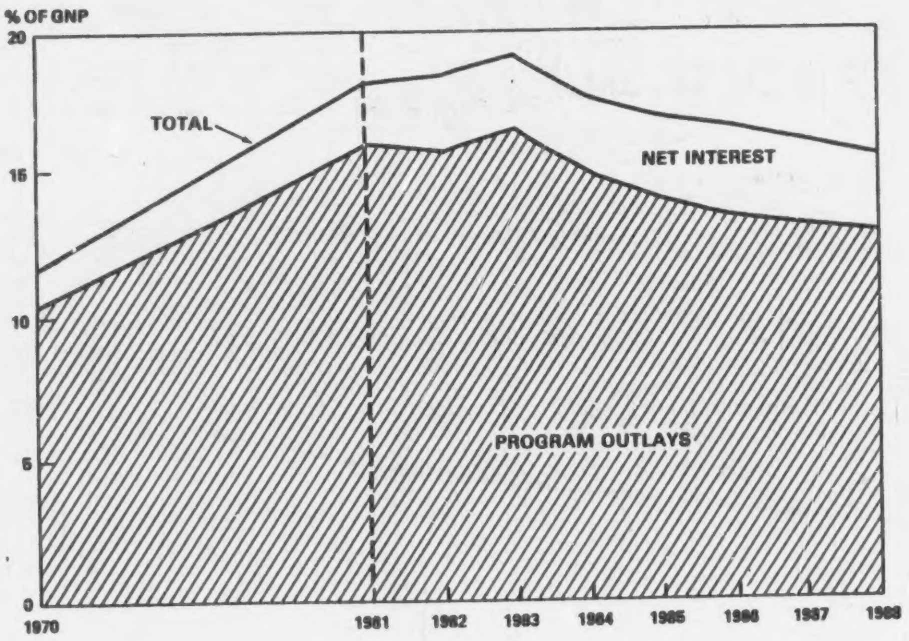


DEFICIT SHARE OF GNP

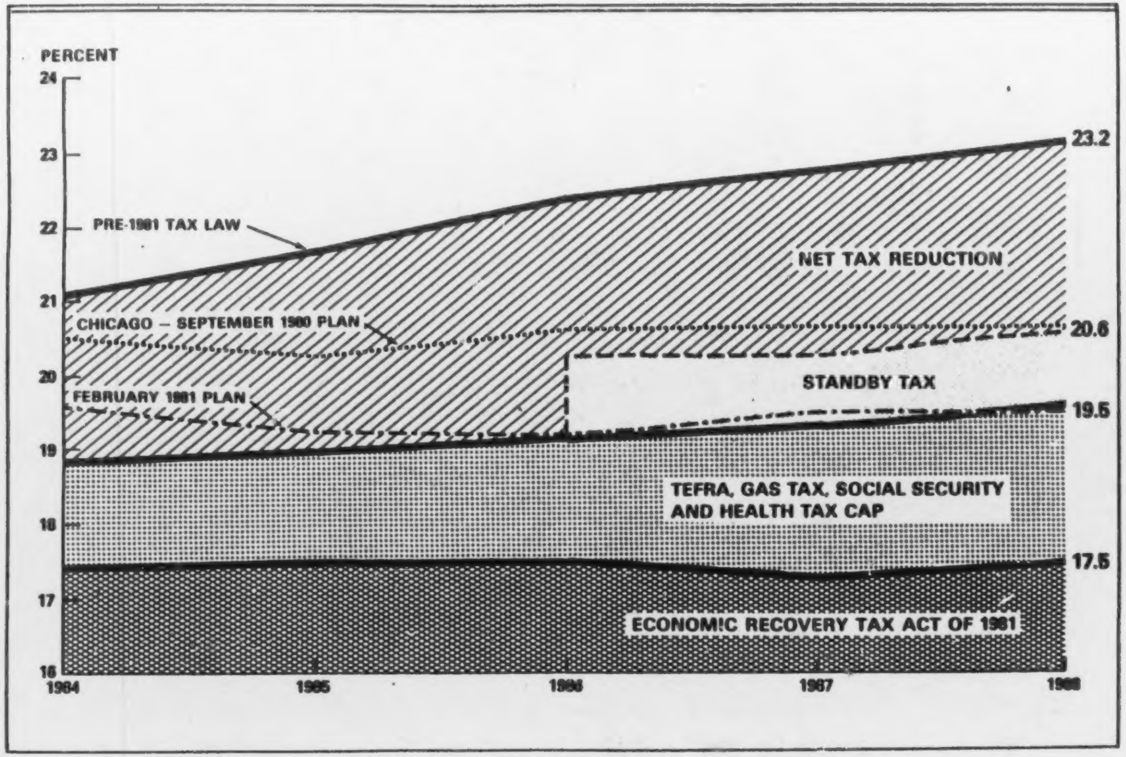


DEFICIT ABSORPTION OF NET PRIVATE SAVINGS

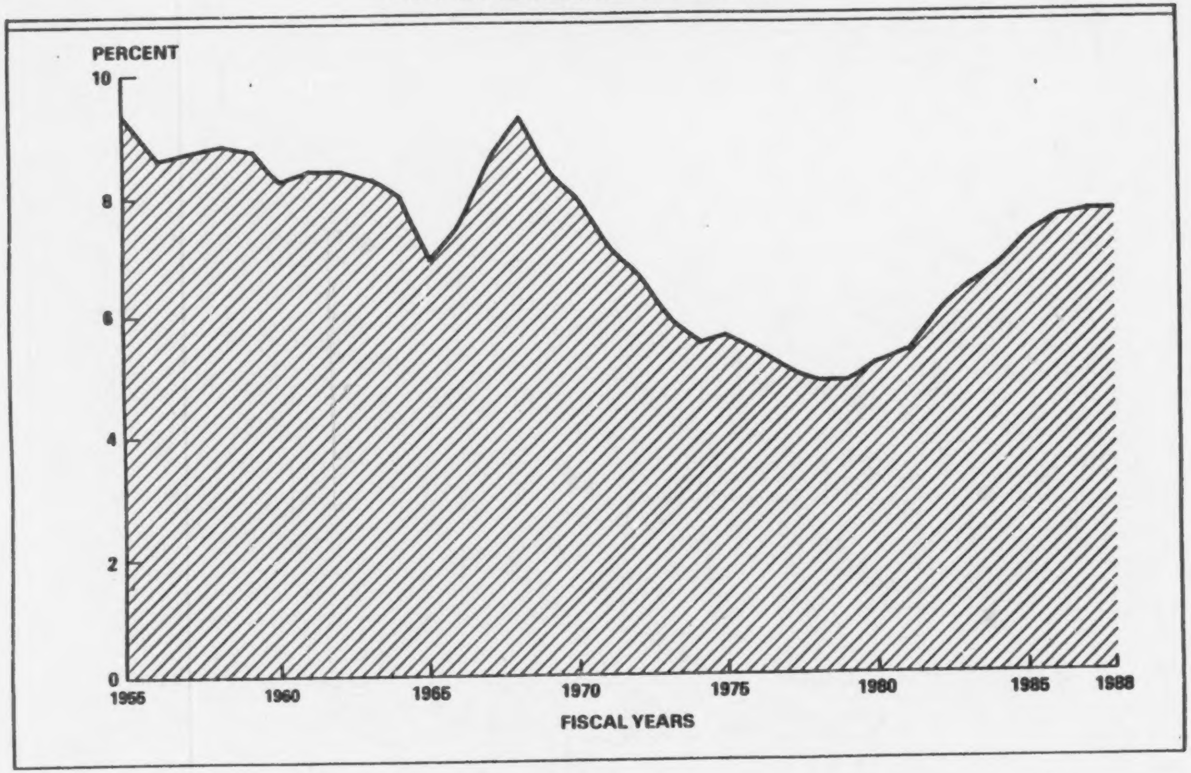
NON-DEFENSE SPENDING AS SHARE OF GNP



CHANGES IN TAX BURDEN AS A SHARE OF GNP

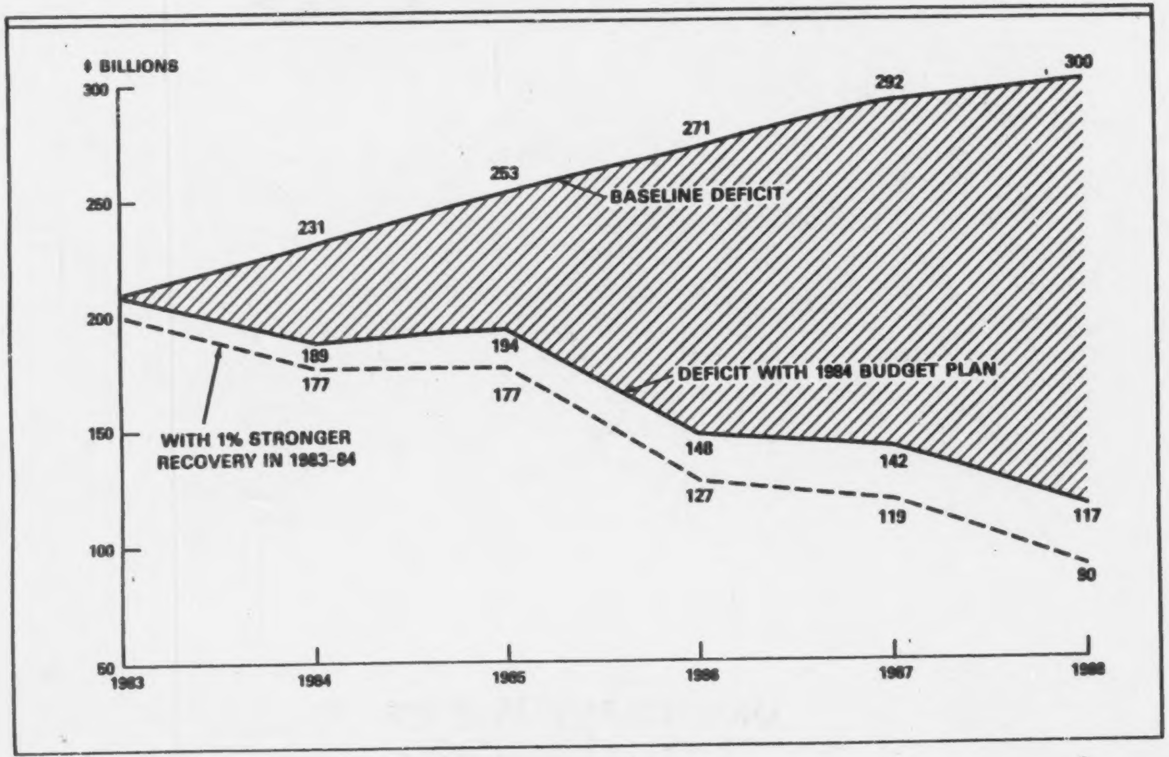


DEFENSE OUTLAYS
AS A SHARE OF GNP



PART II — SOURCE OF THE STRUCTURAL DEFICIT

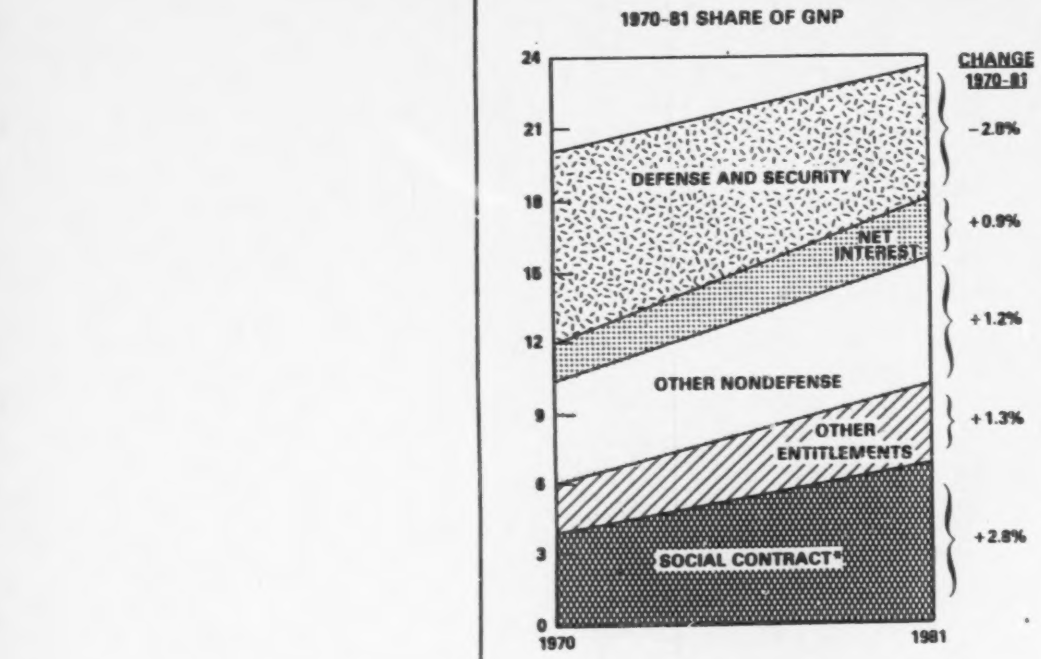
DEFICIT OUTLOOK AT A GLANCE: BASELINE VS. 1984 BUDGET PLAN



SOURCES OF THE STRUCTURAL DEFICIT

- The baseline deficit totals $1,347 billion over 1984-1988 and averages more than 6.5% of GNP — posing a serious threat to sustained economic recovery.
- Most of the out-year baseline deficit is "structural" representing the cumulative impact of 15 years of fiscal policy developments and economic trends. The three primary contributing forces are:
  - The doubling of constant dollar domestic spending from 1970-1981. This increased the cost of transfer payments and discretionary programs from 10¢ to 16¢ on every dollar of GNP — three-fifths of which was locked into automatic entitlements.
  - The prolonged economic adjustment of 1981-83 due to the unwinding of the 1970's inflationary disorder built into the national economy. This abrupt, severe disinflation process has dramatically lowered the long-term path of GNP and revenues and added enormous permanent debt service costs to the budget.
  - Failure during the first two budget cycles to restrain indexed benefit growth and significantly reform the big medical and retirement entitlement programs.

INHERITED FISCAL IMBALANCE

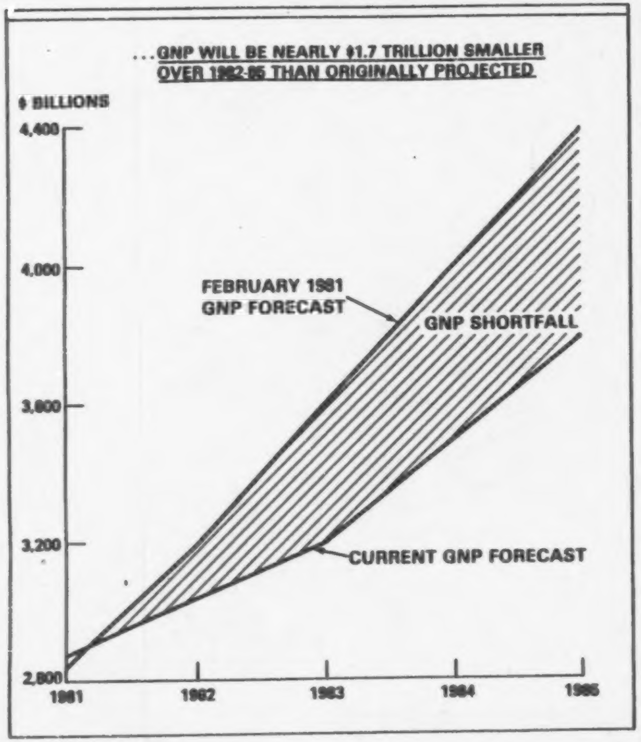


*SOCIAL SECURITY, MEDICARE, AND MEDICAID

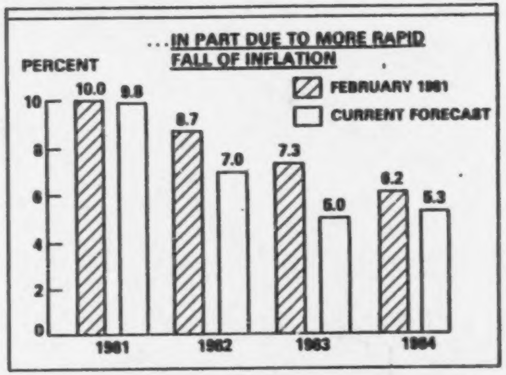
1970's Sources of the Structural Deficit

- Constant dollar cost of social contract programs quadrupled from 1963-1981 — rising from $50 to $220 billion (FY 1983$)
- Together with rapid growth in other entitlements, the overall entitlement claim on GNP rose by two-thirds — from 6% to 10% of GNP
- The overall non-defense claim expanded by 50% — from 12¢ to 18¢ on every dollar of GNP
- At the same time, a decade of neglect and underfunding caused severe deterioration of national defense capabilities — with budget resources at a low, unsustainable 5.5% of GNP
- The huge, structural imbalance in the inherited 1981 budget thus reflected:
  - Record overall spending at 23.6% of GNP that was driving up taxes and deficits
  - Defense spending that was far too low — imposing unfunded claims on future budgets
  - Automatic entitlement spending equaling 10¢ on every dollar of GNP — imposing high and rising claims on future budgets

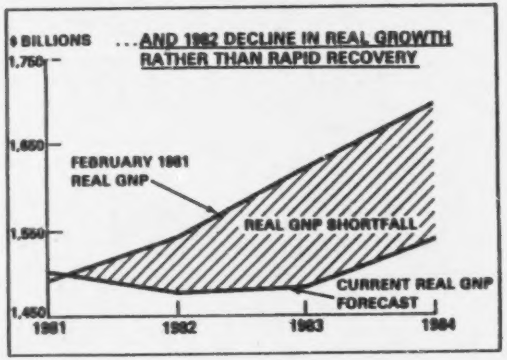
RAPID DISINFLATION AND DEEP RECESSION HAVE DRASTICALLY REDUCED GNP



...GNP WILL BE NEARLY $1.7 TRILLION SMALLER OVER 1982-85 THAN ORIGINALLY PROJECTED

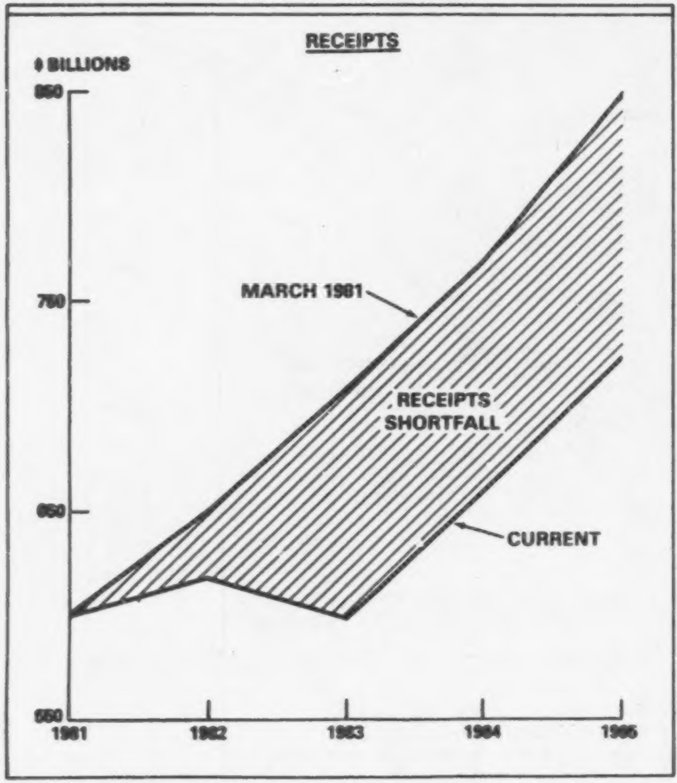


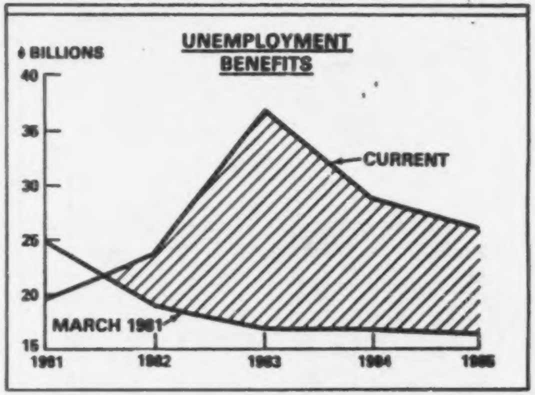
...IN PART DUE TO MORE RAPID FALL OF INFLATION

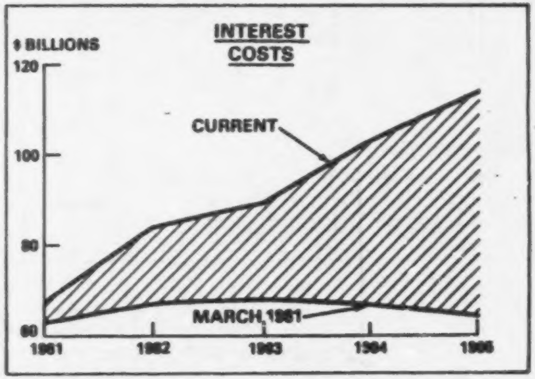


...AND 1982 DECLINE IN REAL GROWTH RATHER THAN RAPID RECOVERY

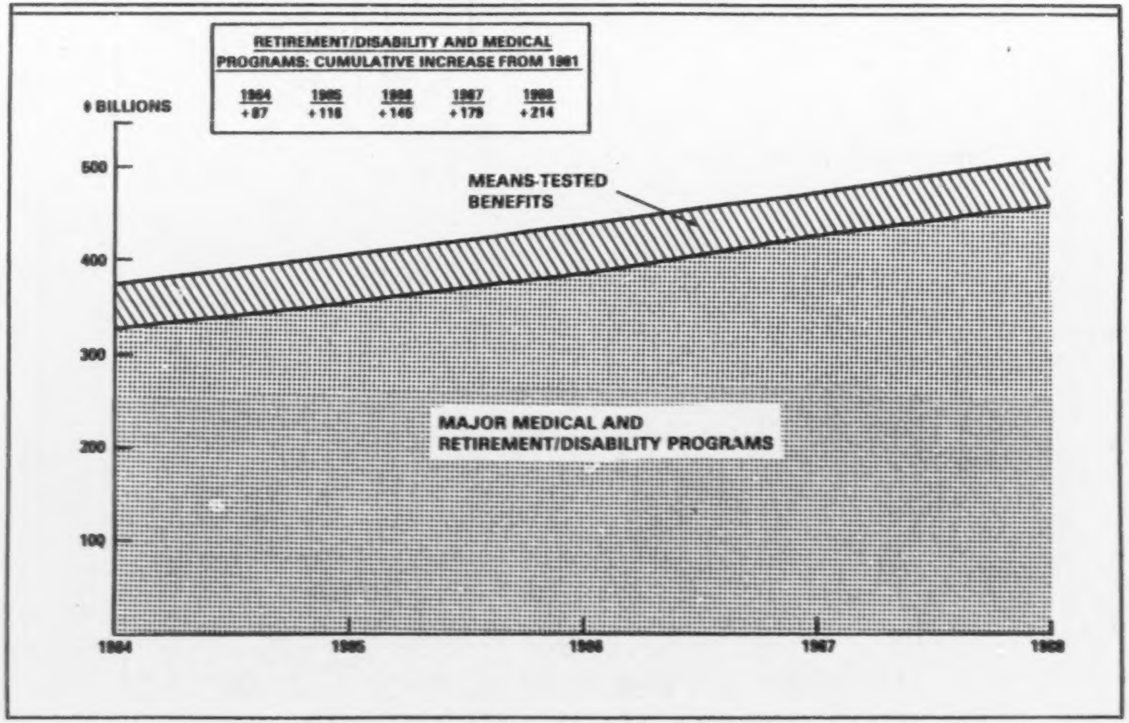
BUDGET IMPACT OF CHANGED ECONOMIC OUTLOOK





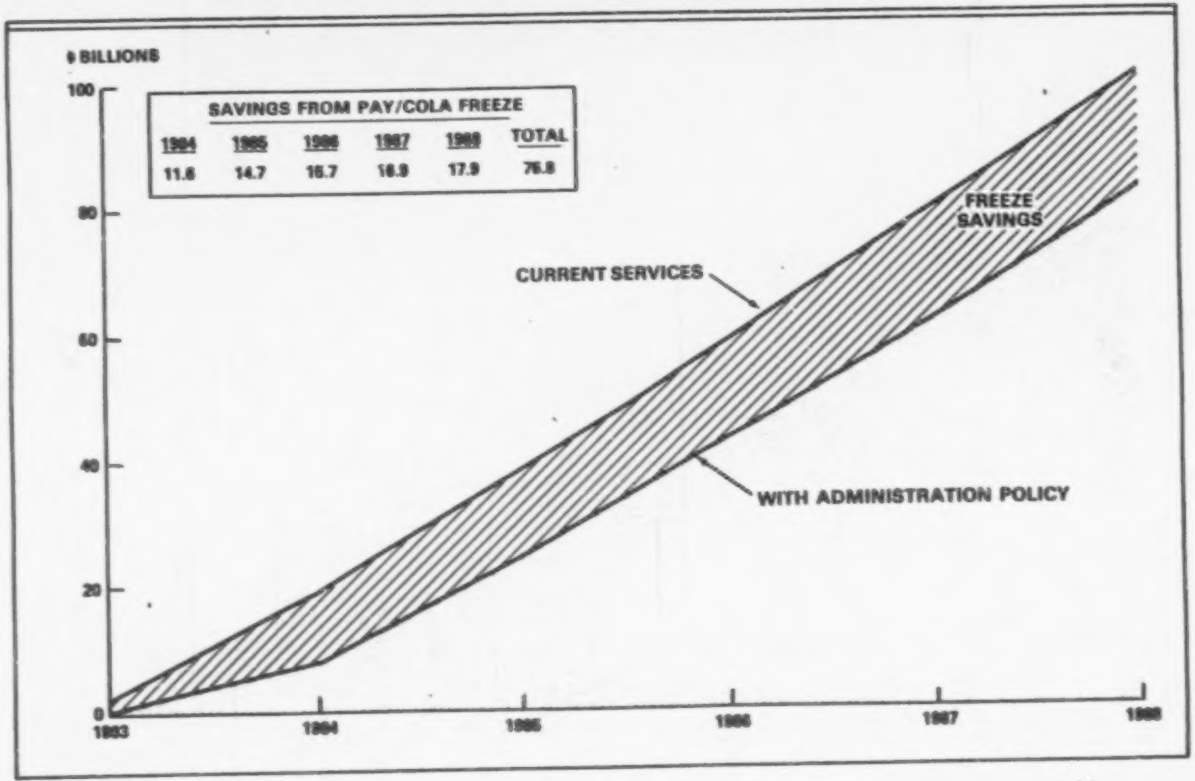


COMPOSITION OF CURRENT SERVICES BASELINE FOR TRANSFER PAYMENTS



PART III — MAJOR PROGRAM HIGHLIGHTS

BUDGET IMPACT OF FREEZE ON BASELINE COSTS OF INDEXED PROGRAMS AND PAY



SAVINGS FROM PAY/COLA FREEZE

1984	1985	1986	1987	1988	TOTAL
11.6	14.7	16.7	16.9	17.9	76.8

AGGREGATE FREEZE ON NON-DEFENSE DISCRETIONARY PROGRAMS

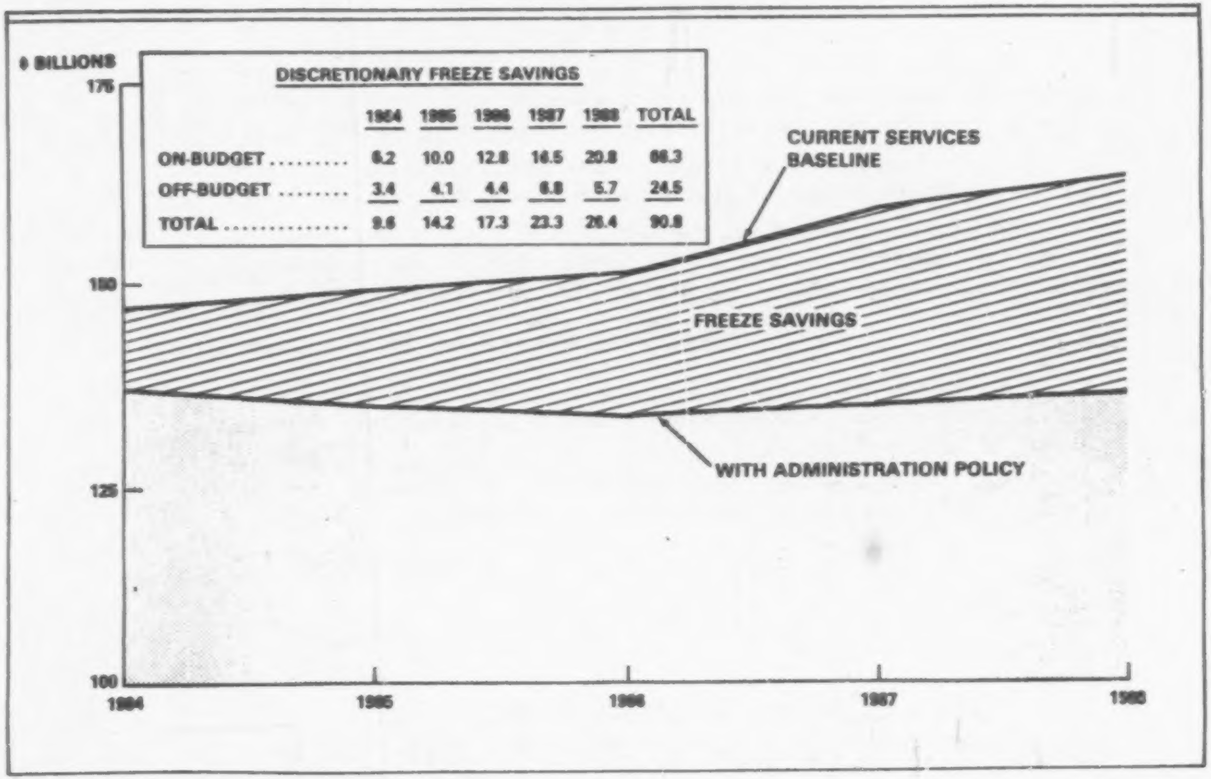
Level Request for Discretionary Programs

- 1984 request for annually funded discretionary programs is $112 billion compared to enacted 1983 appropriations of a similar level. Outlay savings of $4.8 billion compared to 1984 baseline.
- Various trust fund expenditure limits, obligation ceilings and off-budget spending and lending caps save nearly an additional $5 billion in FY 1984 outlays.

Application of Aggregate Freeze Concept

- Targeted high priority programs funded at levels above 1983 appropriation (e.g. law enforcement and anti-drug program, National Science Foundation, Head Start, displaced workers, veterans health care and transportation infrastructure).
- Most programs funded at actual 1983 appropriations (e.g. handicapped education, preventive health block grant, waste treatment grants and WIC).
- Some lower priority programs reduced to below 1983 appropriation to offset targeted increases (e.g. postal subsidies, energy R&D, EDA grants, mass transit, Amtrak and soil conservation).

BUDGET IMPACT OF DISCRETIONARY PROGRAM FREEZE



DISCRETIONARY FREEZE SAVINGS

	1984	1985	1986	1987	1988	TOTAL
ON-BUDGET	6.2	10.0	12.8	16.5	20.8	66.3
OFF-BUDGET	3.4	4.1	4.4	6.8	5.7	24.5
TOTAL	9.6	14.2	17.3	23.3	26.4	90.8

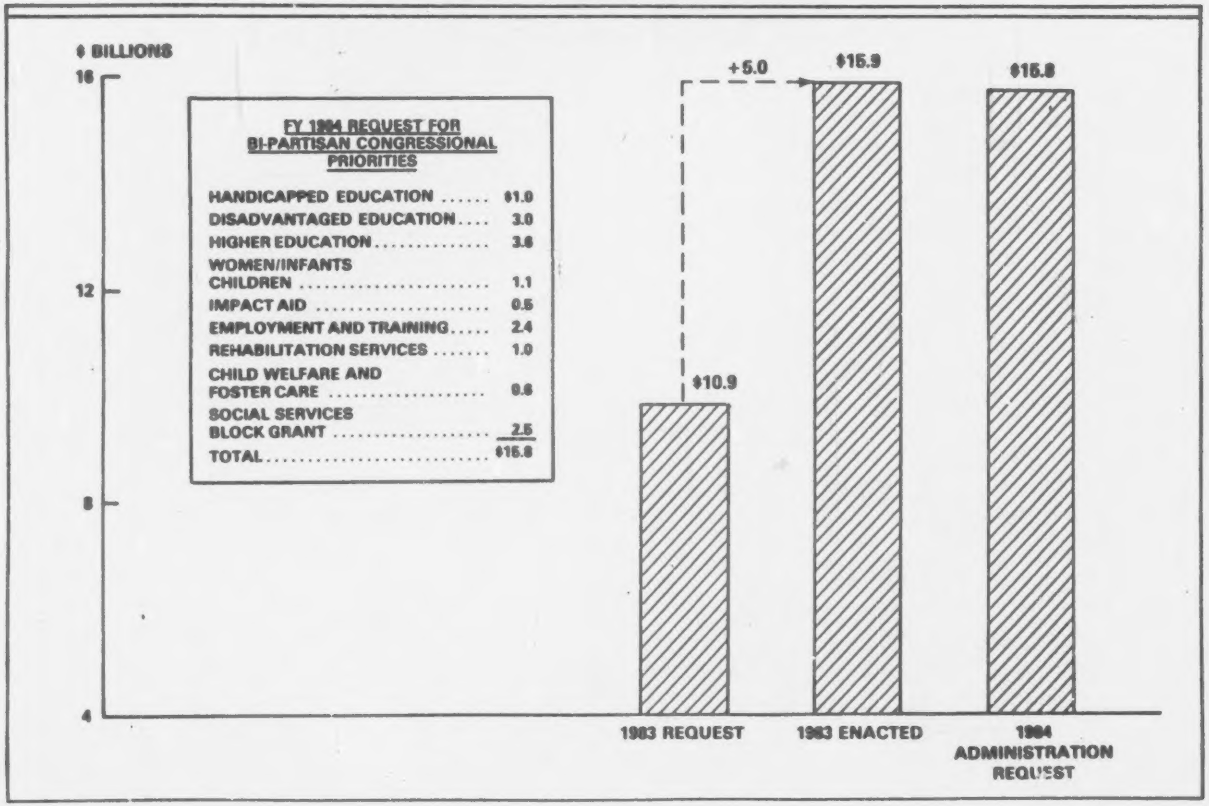
DOMESTIC PROGRAM INCREASES IN FY 1984 BUDGET

(BUDGET AUTHORITY, IN MILLIONS OF DOLLARS)

PROGRAM	1983	1984	INCREASE AMOUNT	INCREASE PERCENT
NATIONAL SCIENCE FOUNDATION	$1,099	$1,297	$ + 198	+ 18%
SCIENCE AND MATH BLOCK GRANTS	0	50	+ 50	—
COLLEGE WORK-STUDY	540	850	+ 310	+ 57
HEAD START	912	1,051	+ 139	+ 15
FOSTER CARE	395	440	+ 45	+ 11
DISPLACED WORKERS PROGRAM	50	240	+ 190	+ 380
TRAINING AND EMPLOYMENT SERVICES	3,704	4,281	+ 577	+ 16
VA MEDICAL CARE	8,292	8,900	+ 608	+ 11
LAW ENFORCEMENT	3,045	3,348	+ 303	+ 10
HIGHWAYS*	8,100	12,600	+ 4,500	+ 56
AIRPORTS AND AIRWAYS	4,180	5,031	+ 851	+ 20
TOTAL	$30,317	$38,088	$ + 7,771	+ 26%

*OBLIGATION LIMITATION PRIOR TO PASSAGE OF GAS TAX LEGISLATION

1984 BUDGET: RECOGNITION OF KEY CONGRESSIONAL PRIORITIES



FY 1984 REQUEST FOR BI-PARTISAN CONGRESSIONAL PRIORITIES

HANDICAPPED EDUCATION	$1.0
DISADVANTAGED EDUCATION	3.0
HIGHER EDUCATION	3.6
WOMEN/INFANTS CHILDREN	1.1
IMPACT AID	0.5
EMPLOYMENT AND TRAINING	2.4
REHABILITATION SERVICES	1.0
CHILD WELFARE AND FOSTER CARE	0.6
SOCIAL SERVICES BLOCK GRANT	2.5
TOTAL	$15.8

FARM PRICE SUPPORT FREEZE AND REFORM

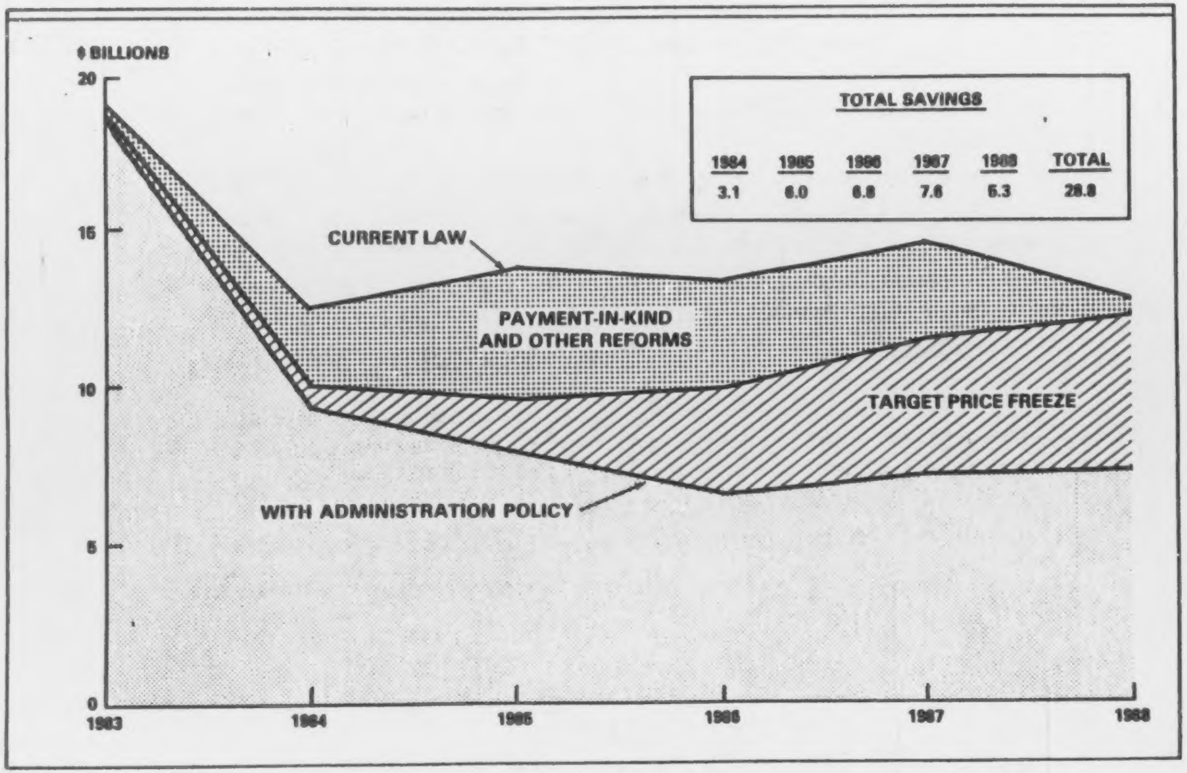
Runaway Costs if We Do Nothing

- Historic record of $19 billion in CCC outlays in 1983 and $86 billion over 1983-88 if current programs are not changed.
- Farm program cost averaged $4.2 billion (constant dollars) per year between 1932-1981. Average would triple — to $12 billion per year — over 1982-88 without Administration reforms.

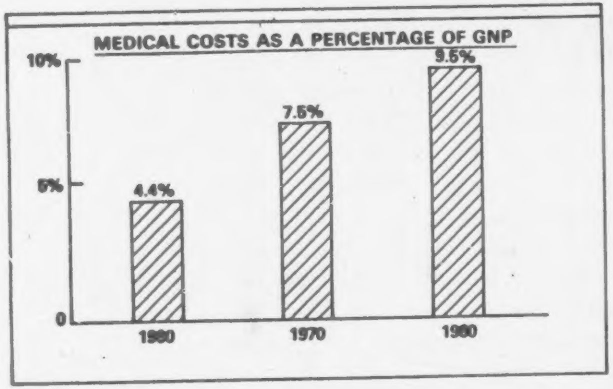
Freeze and Reform Plan

- A payment in kind program (PIK) to cut both farm production and surplus stocks at the same time. (Crop loans forgiven in return for acreage set-aside.)
- A freeze on wheat, corn and other "target" prices in keeping with the drop in inflation and production costs and to discourage over-production.
- An aggressive export policy using commercial and Government channels to increase U.S. farm trade.
- $1/hundred weight assessment to encourage lower dairy production and reduce massive government stocks.
- Saves $3.1 billion in FY 1984 and $29 billion over five years.

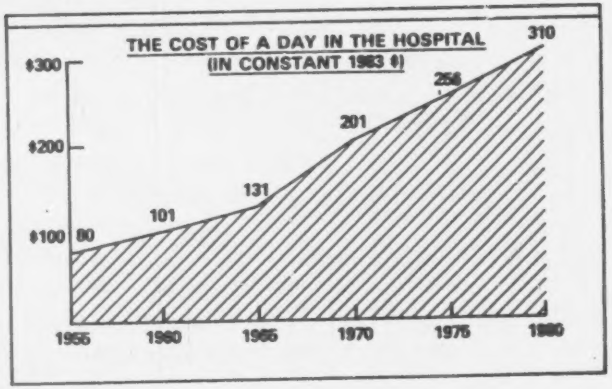
FARM PRICE SUPPORTS



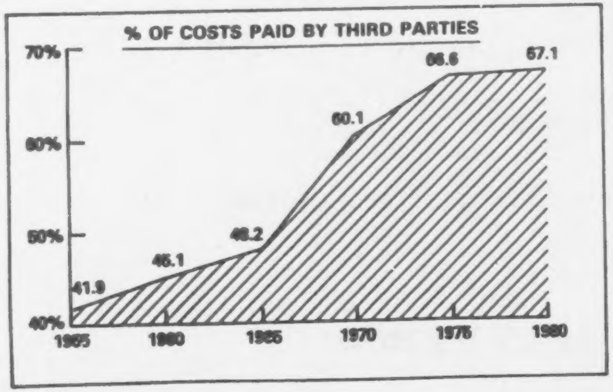
THE NEED TO CONTROL EXPLODING MEDICAL CARE COSTS



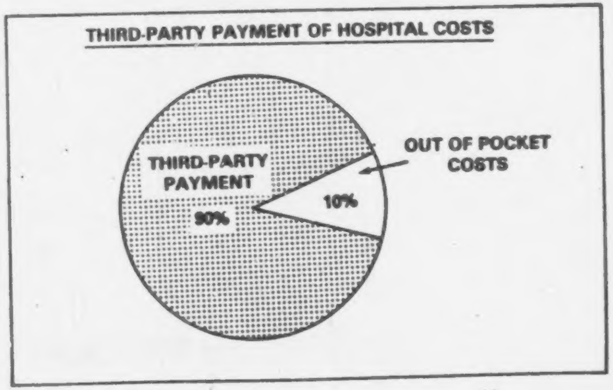
MEDICAL COSTS AS A PERCENTAGE OF GNP



THE COST OF A DAY IN THE HOSPITAL (IN CONSTANT 1983 $)



% OF COSTS PAID BY THIRD PARTIES



THIRD-PARTY PAYMENT OF HOSPITAL COSTS

HEALTH CARE REFORM PACKAGE

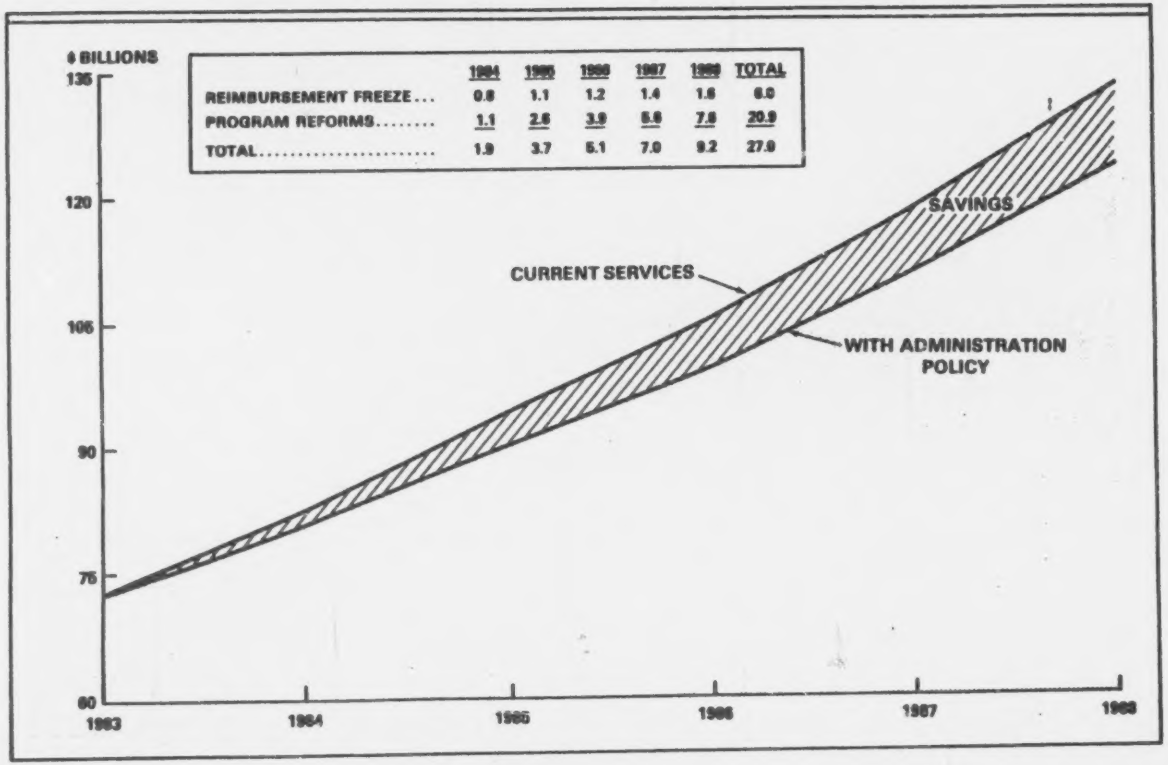
Uncontrolled Costs and Spending

- Inflationary health care system has driven up Medicare/Medicaid outlays from $22 billion in 1975 to $75 billion in 1983. 1984-88 baseline spending would exceed one-half trillion dollars without reforms.

Health Care Reform Package

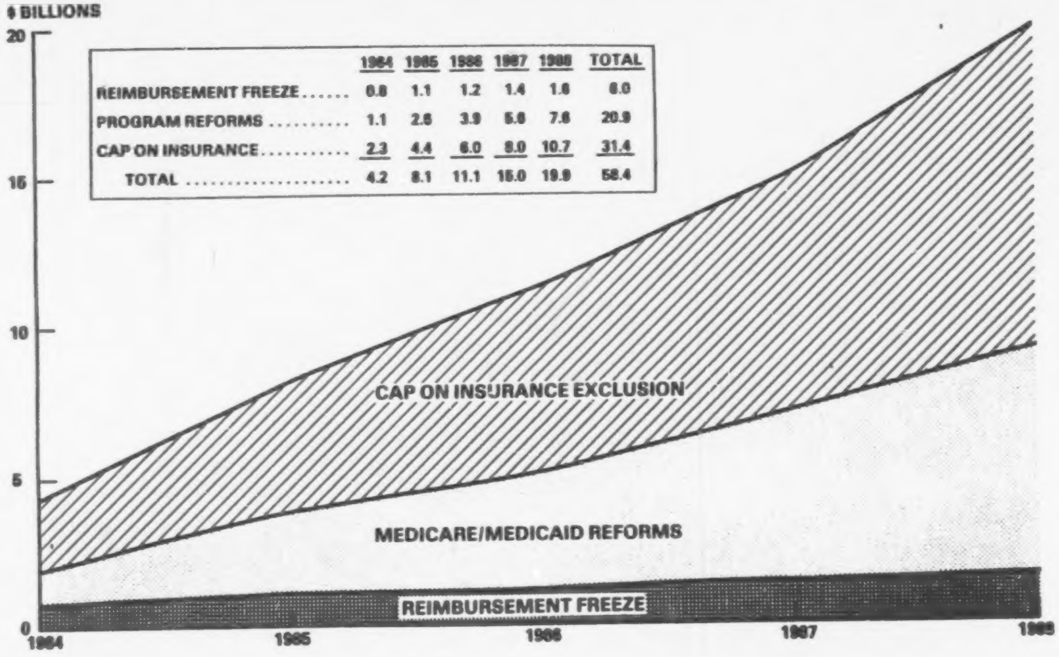
- 1984 freeze on physician payments and hospital reimbursement ceiling saves $6 billion over 5 years.
- Permanent hospital reimbursement reform with fixed payment per case system (DRG). (Five-year savings of $20 billion assumed in current law baseline.)
- Hospital co-payments of 8% ($28/day) through 15th day and 5% ($17.50/day) through 60th day coupled with catastrophic protection thereafter (reduces patient cost of 6-month extended illness from $19,075 to $1,530).
- Phased increase in SMI physician insurance premium to 35% of program cost by 1988 compared to 25% at present and original law provision for 50%.
- Extension of state Medicaid cost control ceilings and mandatory co-payments to reduce over-utilization ($1.00/day for hospital and $1.00/visit for physician services).
- $175/month cap on tax free exclusion of employer health benefit plans to curtail excessive first dollar coverage and encourage consumer cost consciousness.

MEDICAL ENTITLEMENT REFORMS



	1984	1985	1986	1987	1988	TOTAL
REIMBURSEMENT FREEZE...	0.8	1.1	1.2	1.4	1.6	6.0
PROGRAM REFORMS........	1.1	2.6	3.9	5.6	7.6	20.9
TOTAL........................	1.9	3.7	5.1	7.0	9.2	27.0

HEALTH CARE REFORM PLAN
BUDGET SAVINGS



	1984	1985	1986	1987	1988	TOTAL
REIMBURSEMENT FREEZE	0.8	1.1	1.2	1.4	1.6	6.0
PROGRAM REFORMS	1.1	2.6	3.9	5.6	7.6	20.9
CAP ON INSURANCE	2.3	4.4	6.0	8.0	10.7	31.4
TOTAL	4.2	8.1	11.1	15.0	19.9	58.4

BIPARTISAN SOLUTION TO SOCIAL SECURITY SOLVENCY

Five Major Features Impact Unified Budget Deficit

- 6-month COLA freeze.
- 1984 and 1988 payroll tax rescheduling.
- Inclusion of 50% of benefits in income tax base for those above $20/25,000 — to recapture part of unearned benefit.
- Coverage extension to new Federal and non-profit employees; ban on state and local withdrawal.
- Self-employment tax increase to 100% of combined employee/employer rate — with deductibility for employer share.

Budget Savings Due to Bipartisan Solution

Provision	1984	1985	1986	1987	1988	Total
1) COLA freeze	4.2	4.6	4.9	5.4	5.7	24.8
2) Payroll tax rescheduling	5.5	+2.1	0.0	0.0	9.4	13.0
3) Benefit taxation	1.1	4.0	4.7	5.5	6.4	21.7
4) Coverage provisions	1.1	2.0	2.8	3.6	4.6	14.1
5) Self-employment tax	0.6	1.6	1.5	1.6	1.9	7.1
6) SSI and other	+0.2	+0.2	+0.2	+0.3	+0.3	+1.2
7) Total	12.2	10.0	13.6	15.8	27.7	79.4

CIVIL SERVICE RETIREMENT SYSTEM REFORM

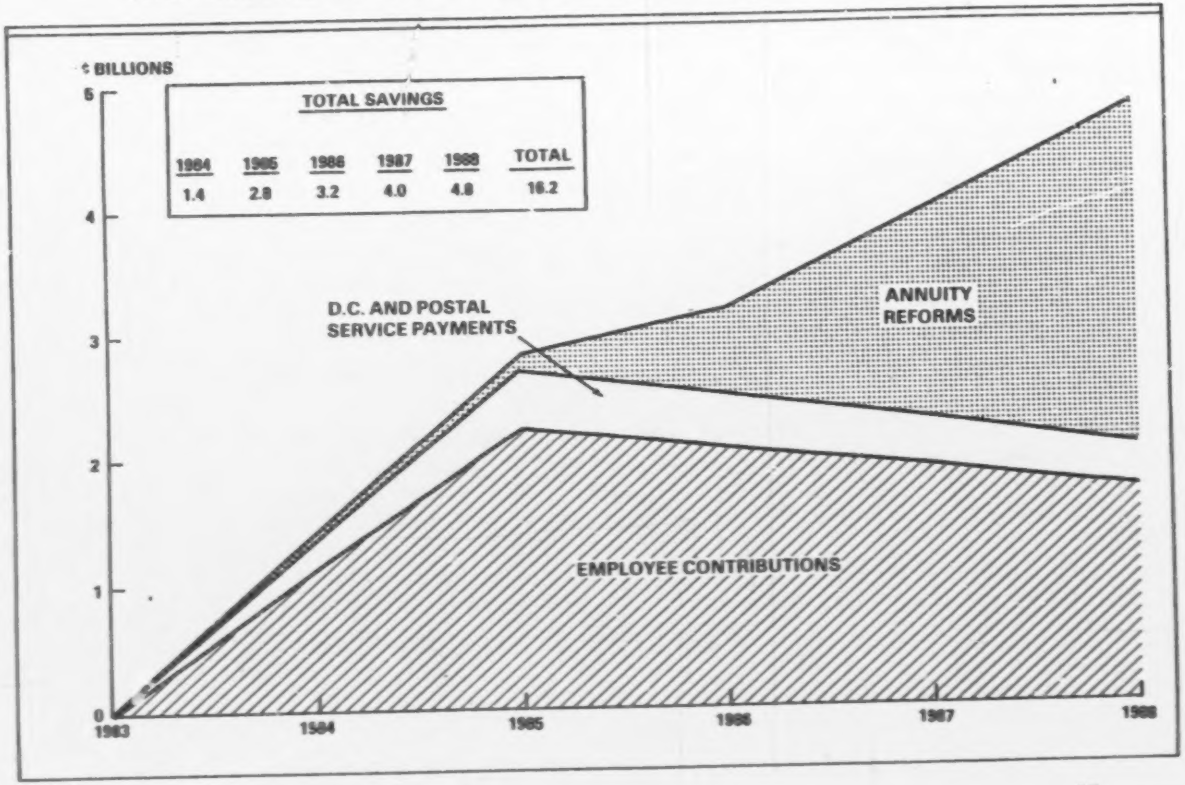
Current System Not Affordable or Viable

- $499 billion unfunded liability.
- System cost equals 37% of Federal payroll — most costly/generous system known.
- GS-14 who retired ten years ago at age 55 now receives $34,140/year annuity plus Federal health benefits.
- Retirement outlays up from $2.8 billion in 1970 to $21.1 billion in 1983 — with 1984-88 baseline costs of $121 billion absent reform.

Proposed Civil Service Retirement Reform Plan

- Reduces long-run system costs to 22% of payroll through:
  - Shift to High-Five;
  - 10-year phase-in of 5%/year annuity reduction for retirement between 55 and 65;
  - Modification of annuity replacement formula, if necessary.
- Employee contribution raised from 7% to 11% (half of reformed system cost) in two steps over 1984-85.
- Postal Service and D.C. required to fund fair share of costs for employees who participate in Civil Service Retirement system.
- Reform plan saves $1.4 billion in 1984 and $16.[illegible] billion over 5 years.

BUDGET SAVINGS FROM STRUCTURAL REFORMS OF FEDERAL RETIREMENT PROGRAMS



TOTAL SAVINGS

1984	1985	1986	1987	1988	TOTAL
1.4	2.8	3.2	4.0	4.8	16.2

MEANS-TESTED ENTITLEMENT REFORM

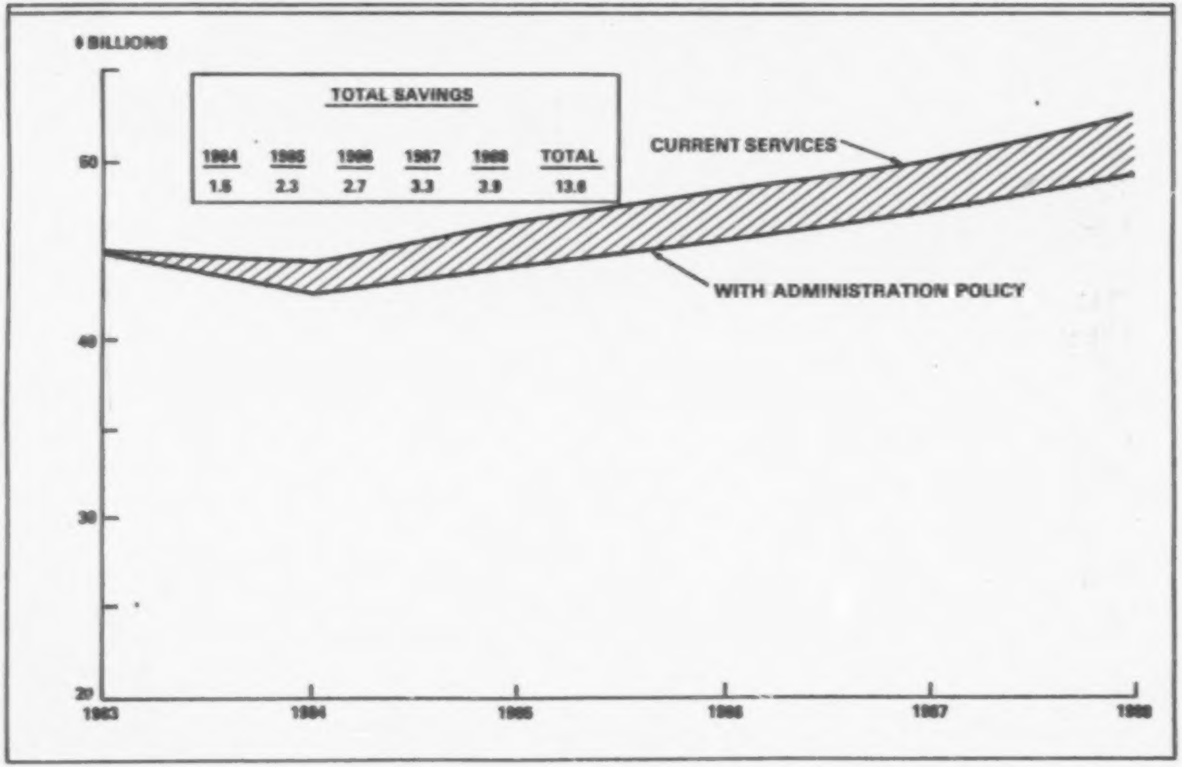
Baseline Costs and Proposed Savings

- Enacted Administration reforms have curtailed explosive welfare spending growth of 1970's — but baseline costs are still $243 billion over 1984-88 without further reforms.
- Proposed reforms save nearly $14 billion over 5 years — or 5.6% of baseline costs. Major focus is on error rate reduction, mandatory workfare and simplification of eligibility and benefit determination — so benefits to truly needy fully protected. Proposed spending level for these programs still highest in history.

Significant Program Changes

- Food Stamps — mandatory workfare, simplification of benefit calculation by standardizing current shelter and earnings deductions, and reduction of allowable state error rate to 3%.
- Child Nutrition — block grant at 85% of current level for summer feeding, child care and school breakfast program.
- AFDC — mandatory workfare, include all household members in assistance unit, prorate shelter and utility costs if shared household, end parents' benefit when child reaches 16 (conform to Social Security), restructure child support enforcement program incentives, and mandate collection of medical support from absent parents.
- Subsidized Housing Program — count Food Stamps as income, continue lower cost voucher approach and cap net additional subsidized units at average of 85,000 per year.

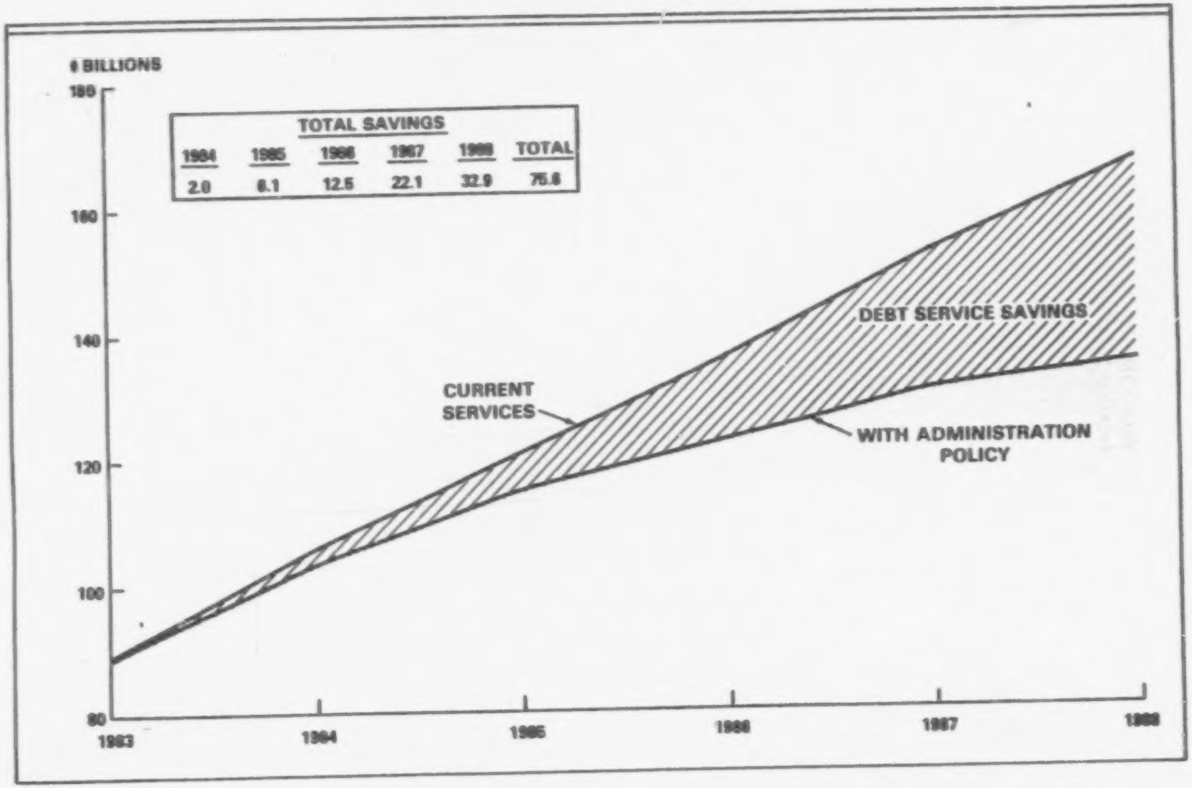
MEANS-TESTED ENTITLEMENTS



TOTAL SAVINGS

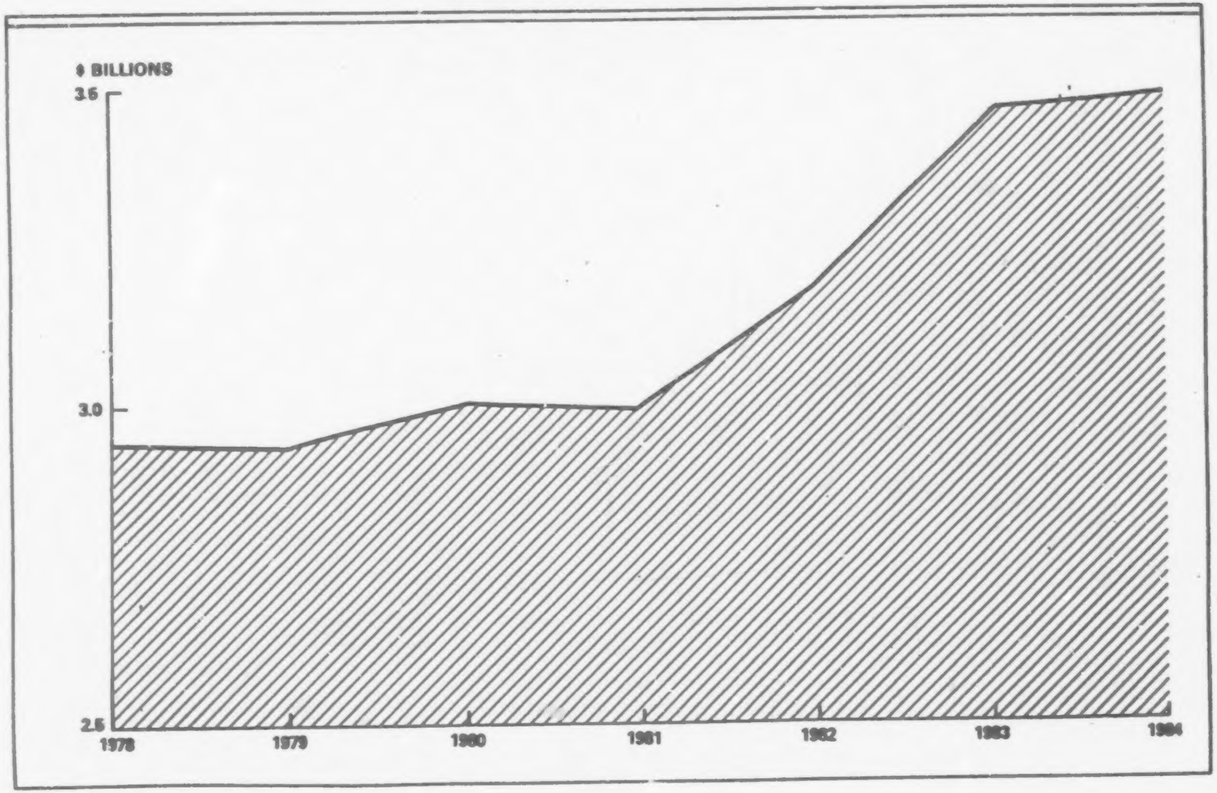
1984	1985	1986	1987	1988	TOTAL
1.6	2.3	2.7	3.3	3.9	13.8

NET INTEREST OUTLAYS

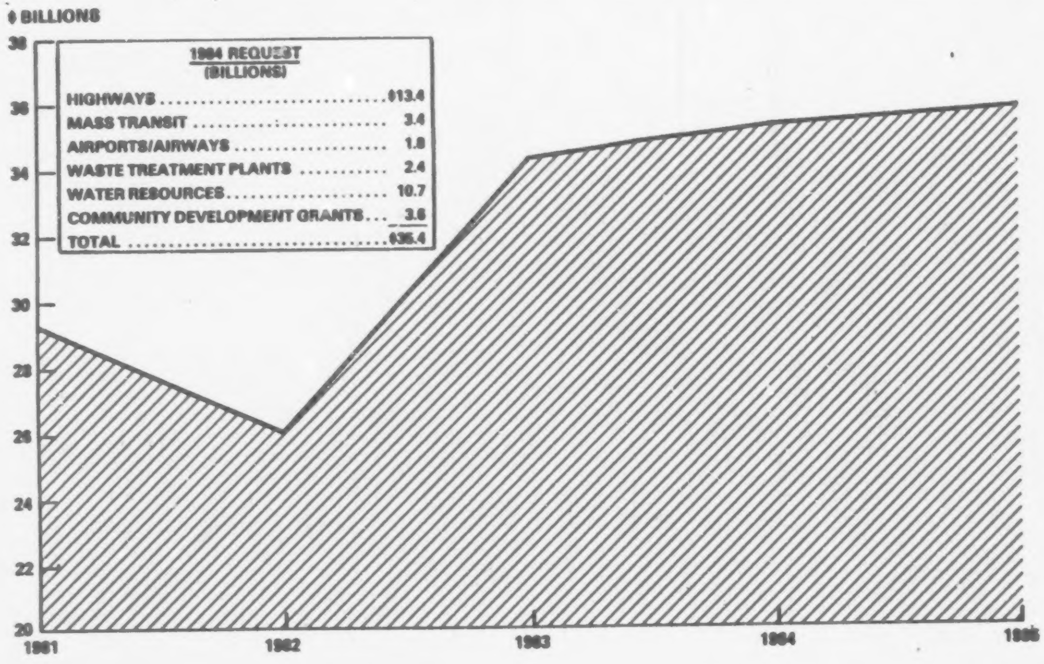


MORE ADEQUATE FUNDING FOR LAW ENFORCEMENT

(CONSTANT FY 1983 DOLLARS)

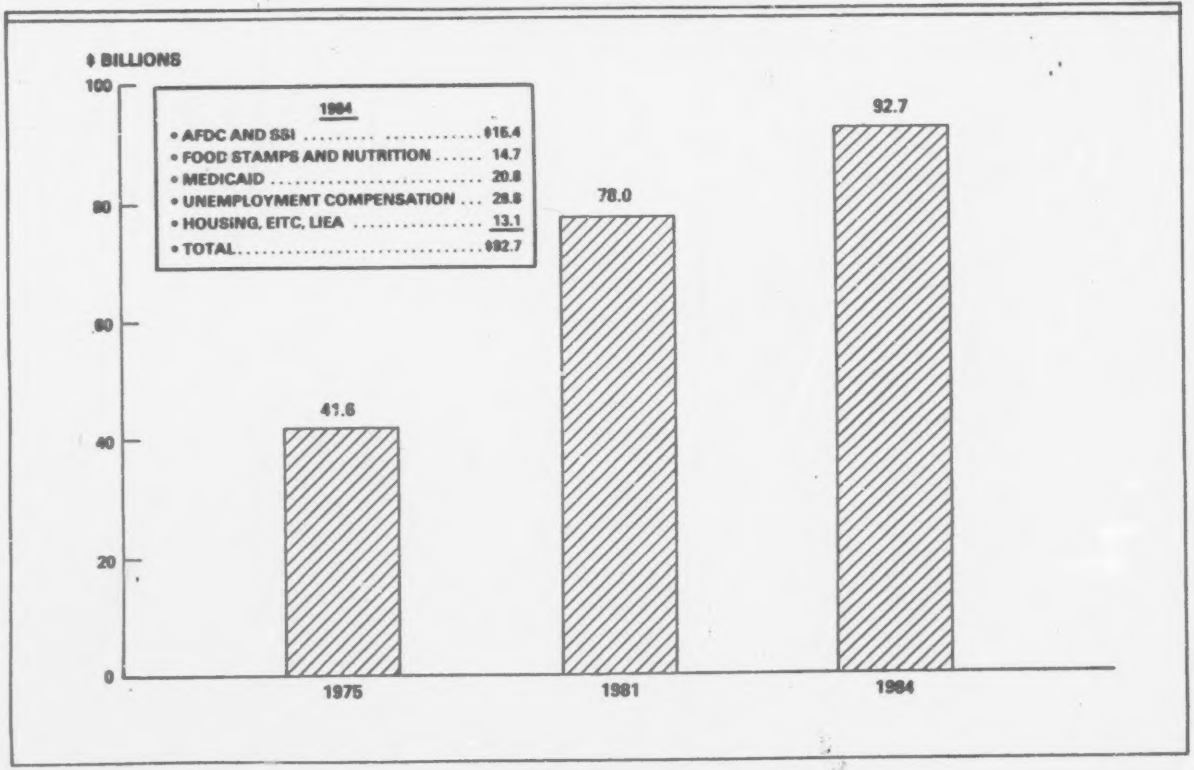


FUNDING FOR PUBLIC INFRASTRUCTURE

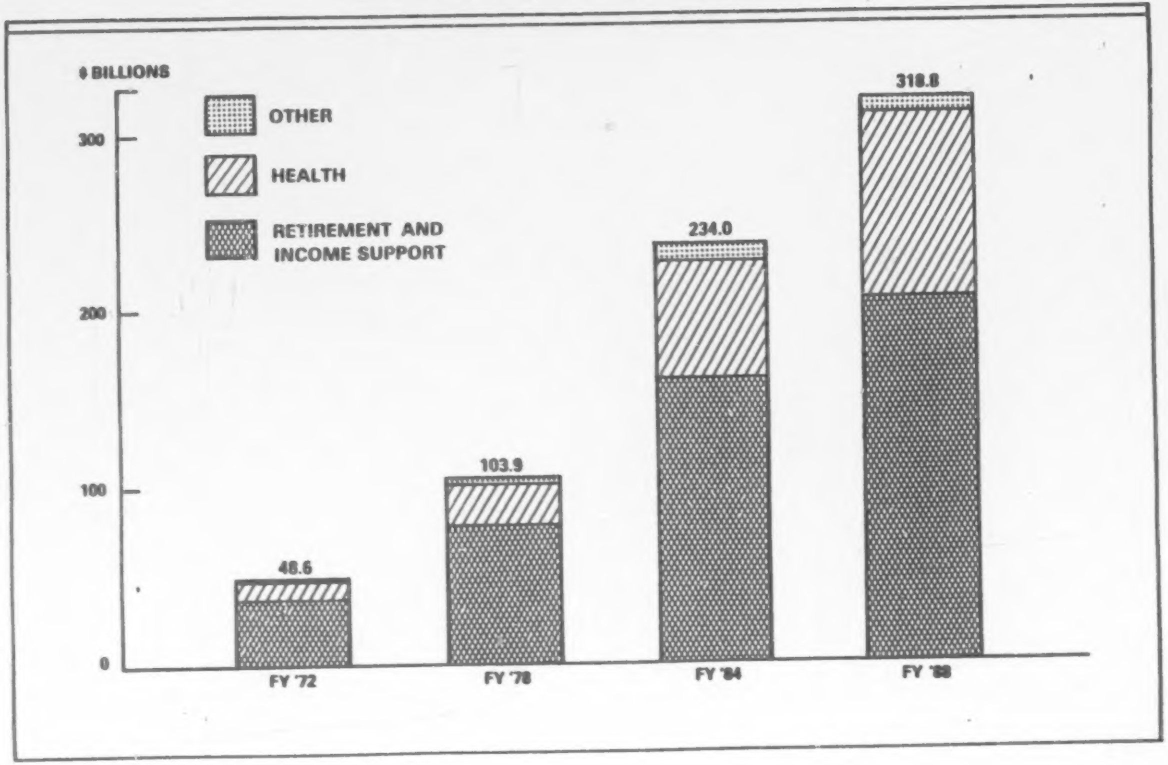


1984 REQUEST (BILLIONS)	
HIGHWAYS	$13.4
MASS TRANSIT	3.4
AIRPORTS/AIRWAYS	1.8
WASTE TREATMENT PLANTS	2.4
WATER RESOURCES	10.7
COMMUNITY DEVELOPMENT GRANTS	3.6
TOTAL	$35.4

MAINTENANCE OF THE SOCIAL SAFETY NET — FEDERAL OUTLAYS FOR UNEMPLOYED AND LOW-INCOME



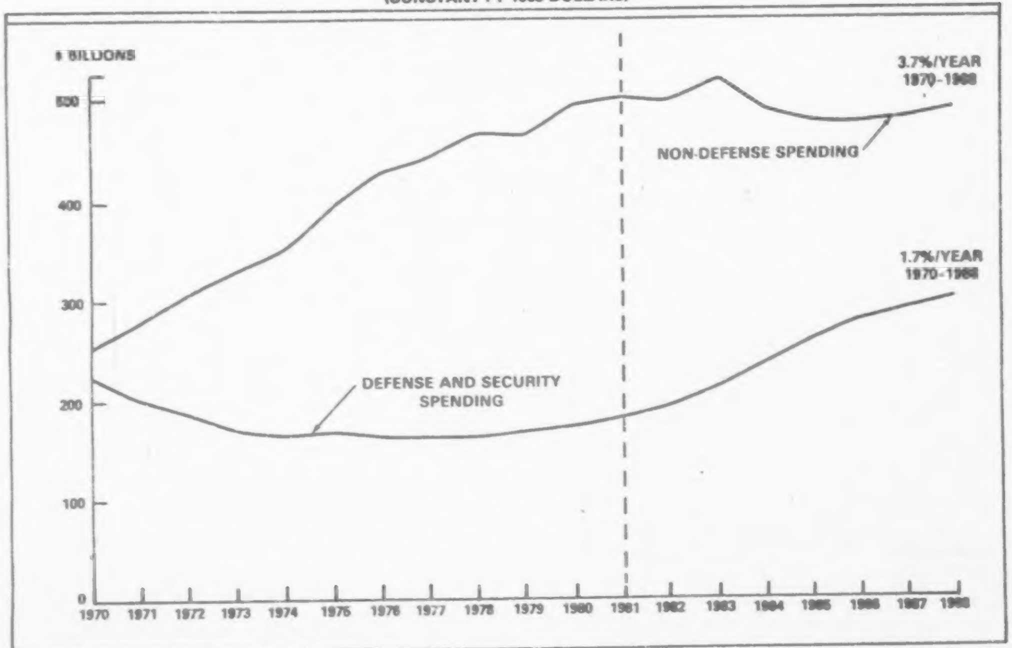
FEDERAL OUTLAYS BENEFITING THE ELDERLY



PART IV — DEFENSE BUDGET

BUDGET PRIORITIES SHIFT IN HISTORICAL PERSPECTIVE

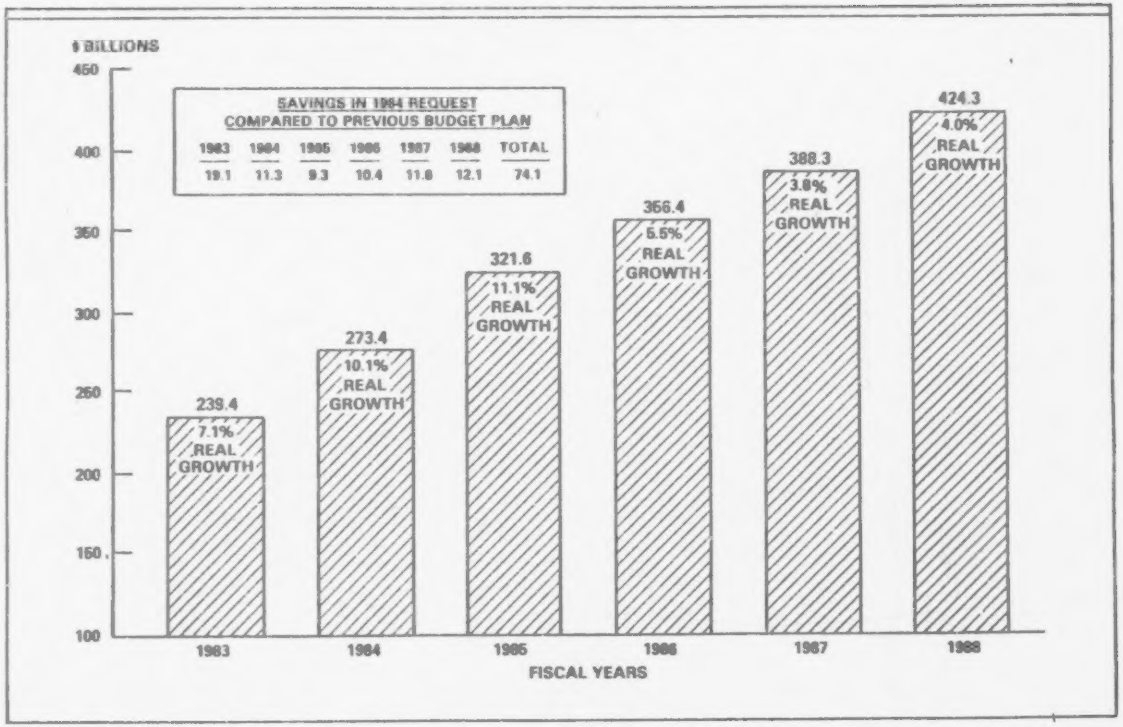
(CONSTANT FY 1983 DOLLARS)



MILITARY RETIRED PAY INCLUDED IN NON-DEFENSE SPENDING
NONDEFENSE SPENDING EXCLUDES NET INTEREST

DEPARTMENT OF DEFENSE BUDGET
1983–1988

(BUDGET AUTHORITY)

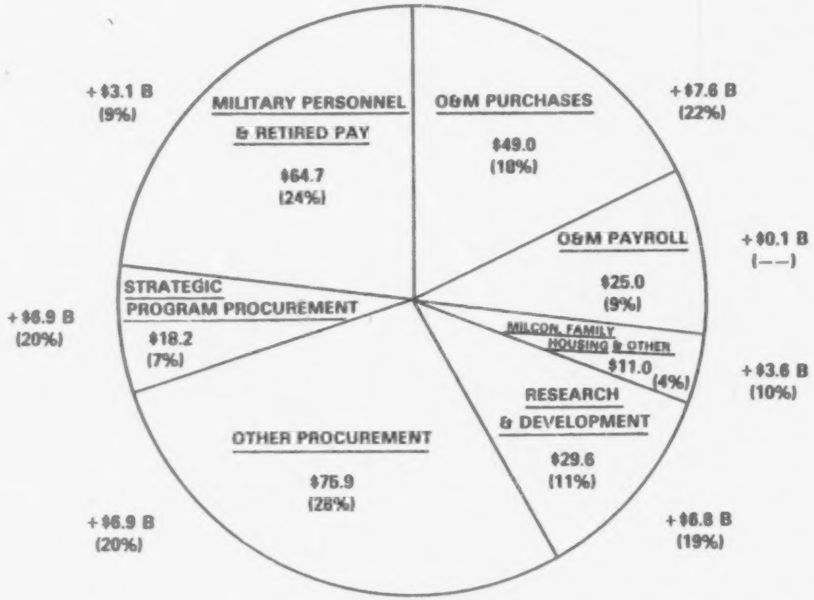


SAVINGS IN 1984 REQUEST
COMPARED TO PREVIOUS BUDGET PLAN

1983	1984	1985	1986	1987	1988	TOTAL
19.1	11.3	9.3	10.4	11.6	12.1	74.1

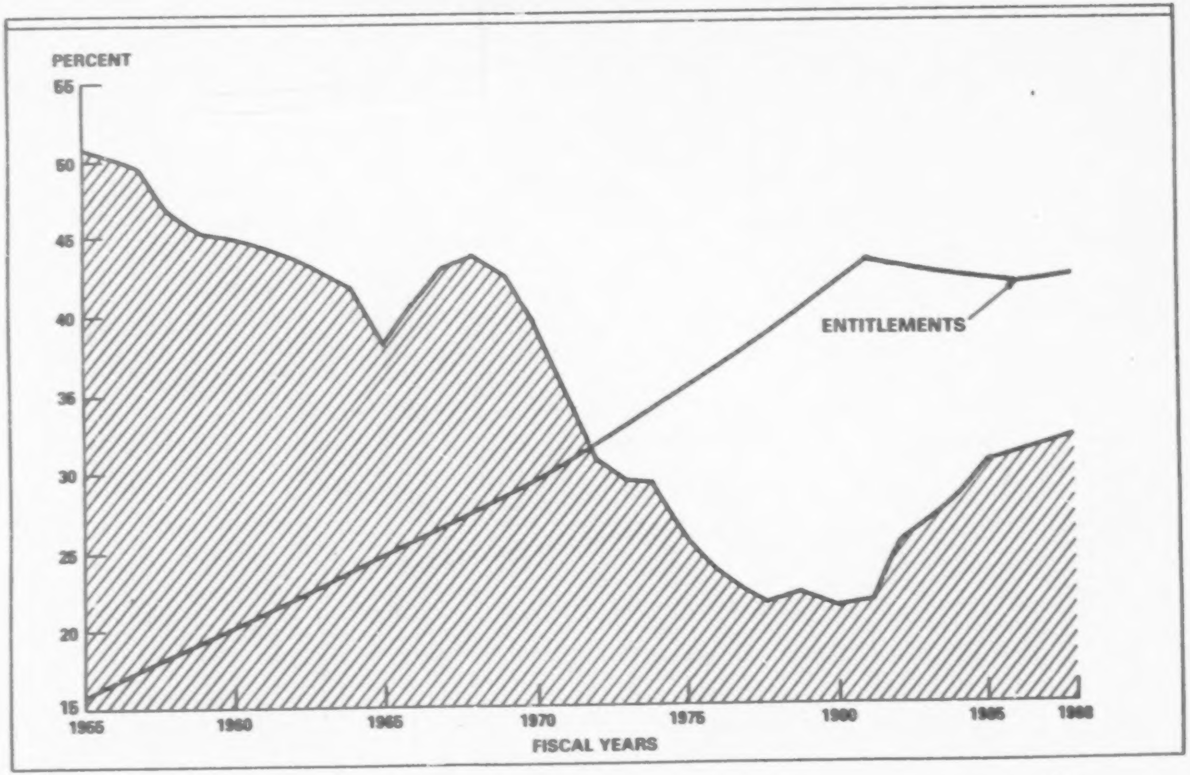
COMPOSITION OF 1984 DOD BUDGET

(BUDGET AUTHORITY; IN BILLIONS $)



$273.4 B (+$35.0 B)

DEFENSE SHARE OF BUDGET



PART V - ECONOMIC ASSUMPTIONS

ECONOMIC ASSUMPTIONS IN 1984 BUDGET

Real GNP

- Recovery begins this quarter and builds steadily until mid-year — averaging 4% real growth thereafter through 1988.
- Moderate recovery reflects steady rebuilding of inflation-damaged economy and avoids boom/bust pattern that could rekindle inflation later.
- 6-year real growth projection equals historic average for post-World War II recoveries, while inflation averages 43% lower than 1978-80.

Unemployment

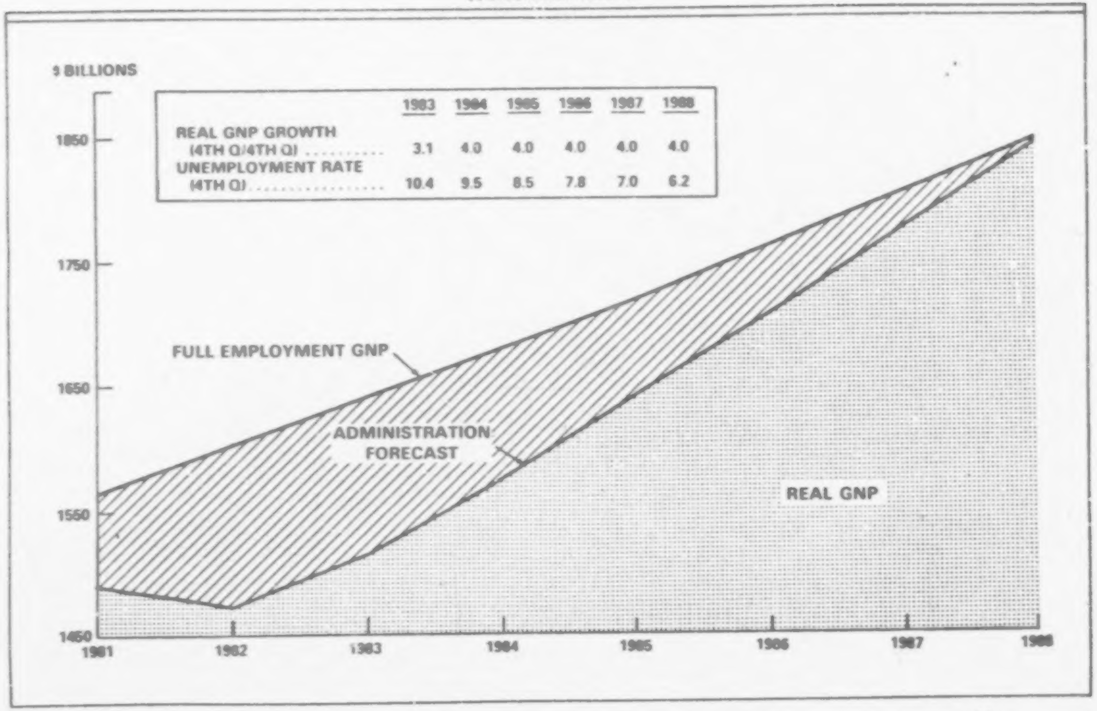
- Unemployment peaks in 1983 first half and steadily declines thereafter — with 1.6 million more jobs by fall 1983 and 4.6 million more by fall 1984.
- In out-years, unemployment rate declines three-fourths of a percent per year — reaching 6.2% by end of 1988 — representing 15 million more jobs than at present.

Inflation and Interest Rates

- Interest rates and inflation continue moderate decline over next several years with T-bill at 5.9% by 1988 and CPI at 4.4%.

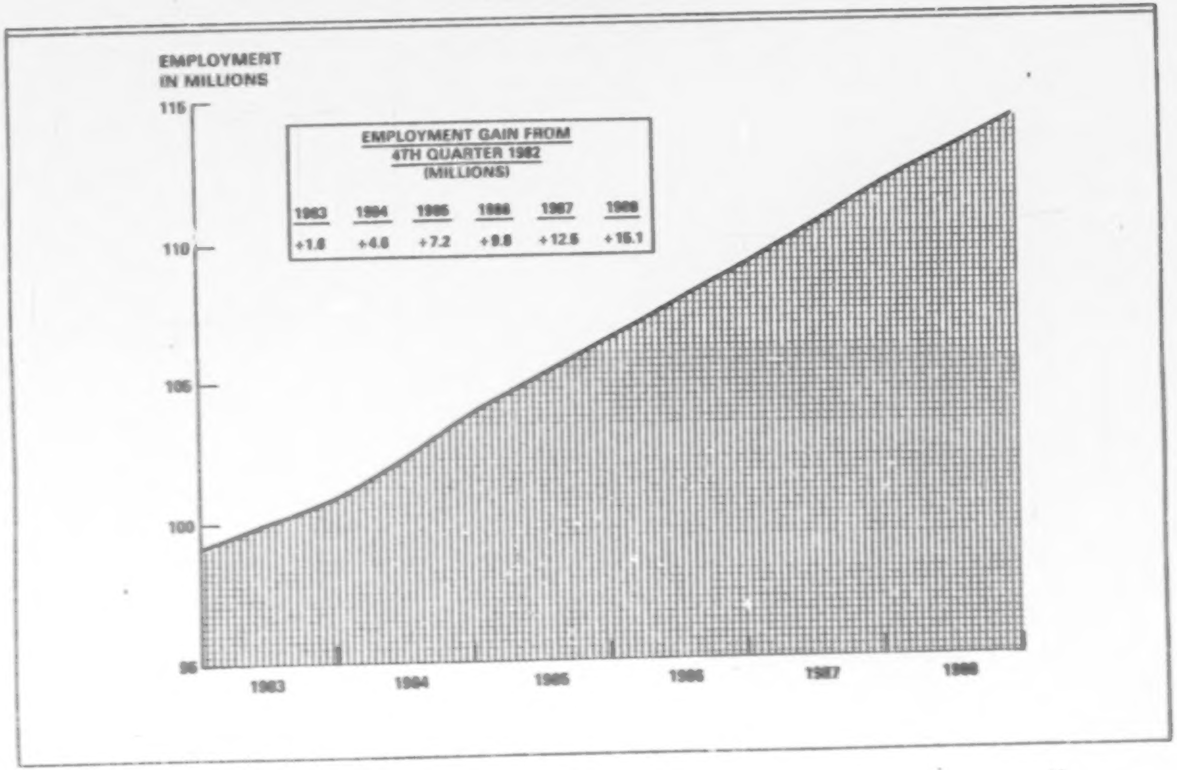
REAL GNP FORECAST VS FULL EMPLOYMENT GNP

(CONSTANT 1972 $)

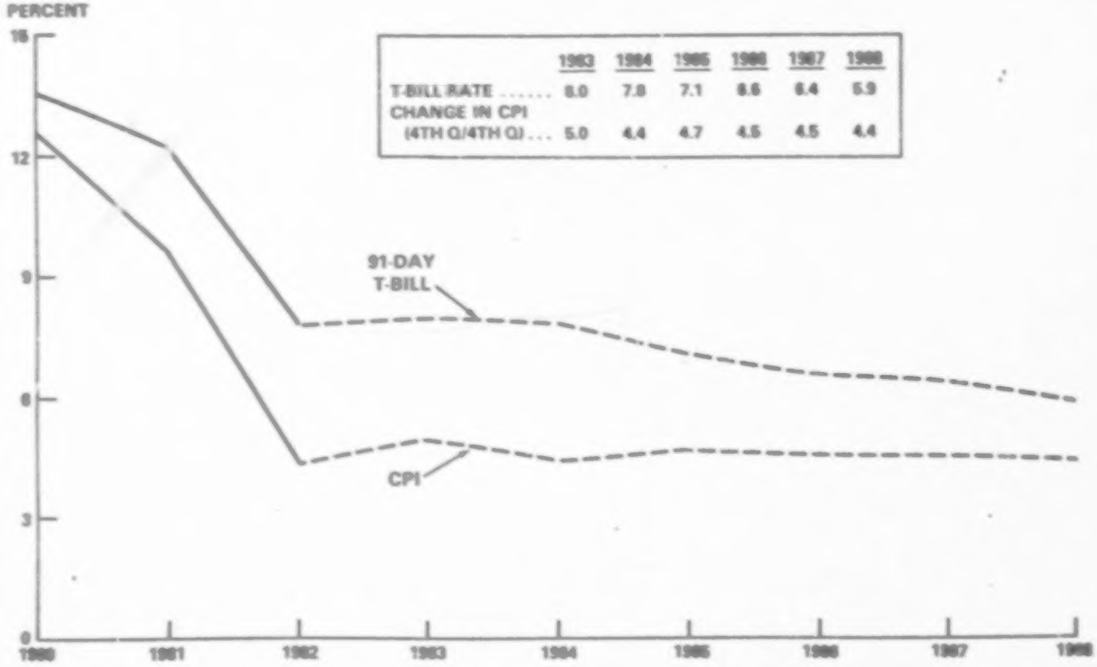


	1983	1984	1985	1986	1987	1988
REAL GNP GROWTH (4TH Q/4TH Q)	3.1	4.0	4.0	4.0	4.0	4.0
UNEMPLOYMENT RATE (4TH Q)	10.4	9.5	8.5	7.8	7.0	6.2

ECONOMIC RECOVERY: 15 MILLION NEW JOBS

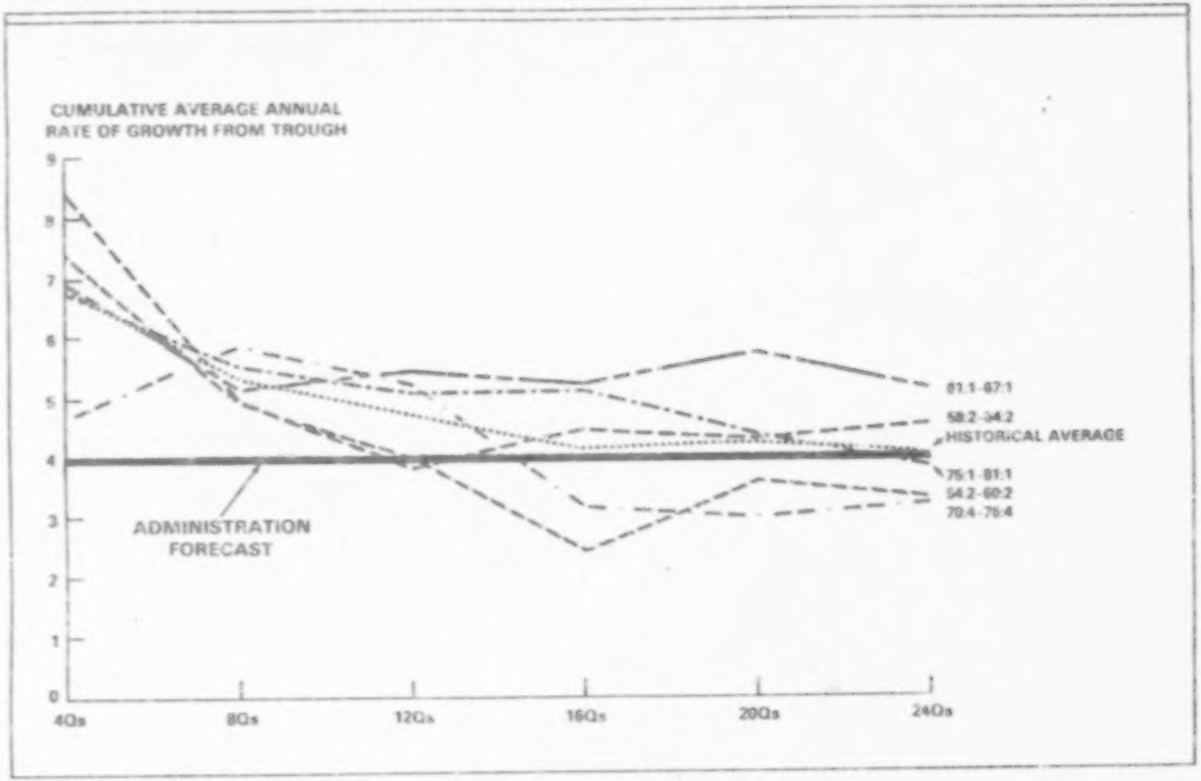


INFLATION AND INTEREST RATE TRENDS

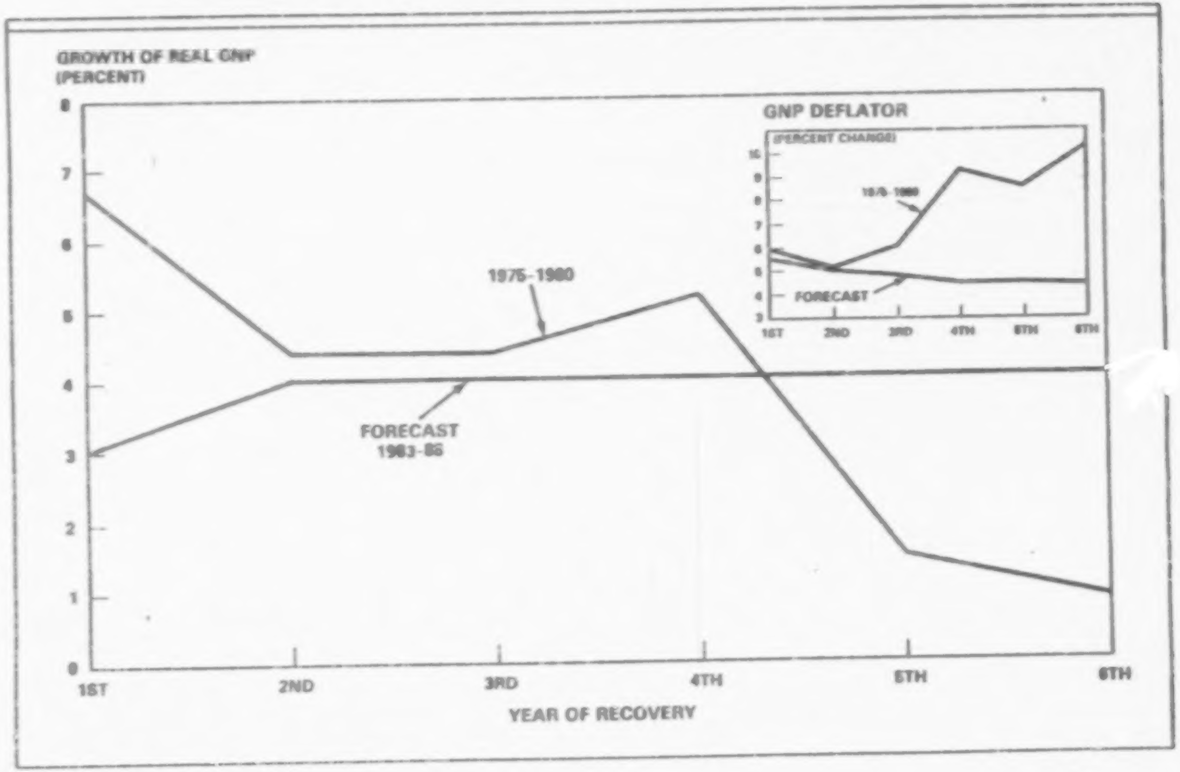


	1983	1984	1985	1986	1987	1988
T-BILL RATE	8.0	7.8	7.1	6.6	6.4	5.9
CHANGE IN CPI (4TH Q/4TH Q) ...	5.0	4.4	4.7	4.5	4.5	4.4

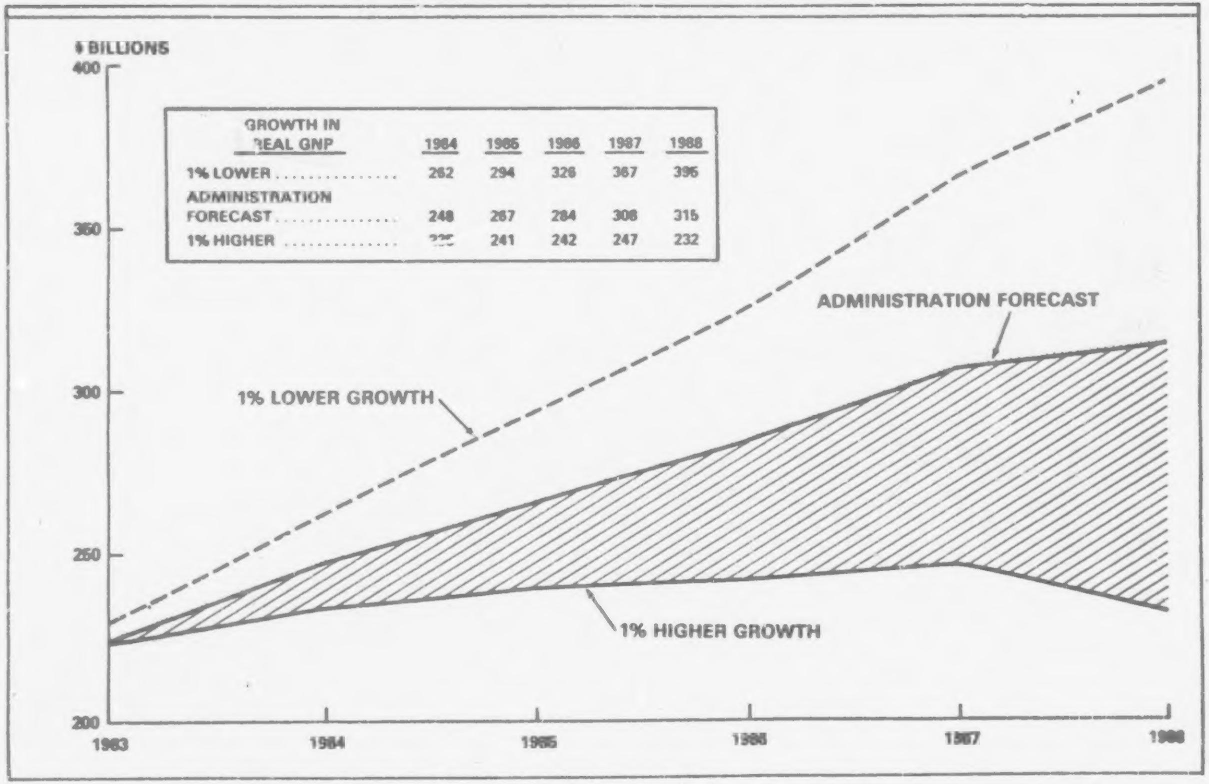
SIX-YEAR REAL GNP GROWTH FORECAST COMPARED TO HISTORICAL RECOVERY CYCLE EXPERIENCE



ADMINISTRATION FORECAST VS 1975 RECOVERY

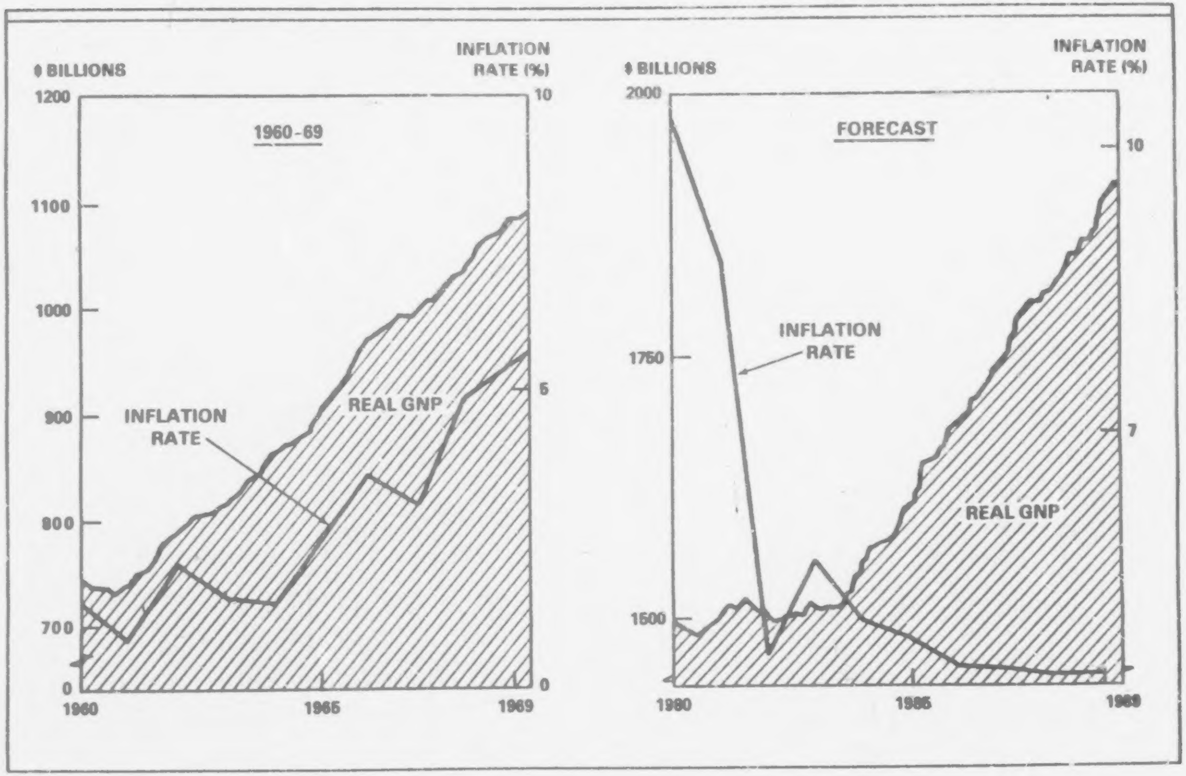


CURRENT SERVICES DEFICITS WITH ALTERNATIVE GROWTH PATHS

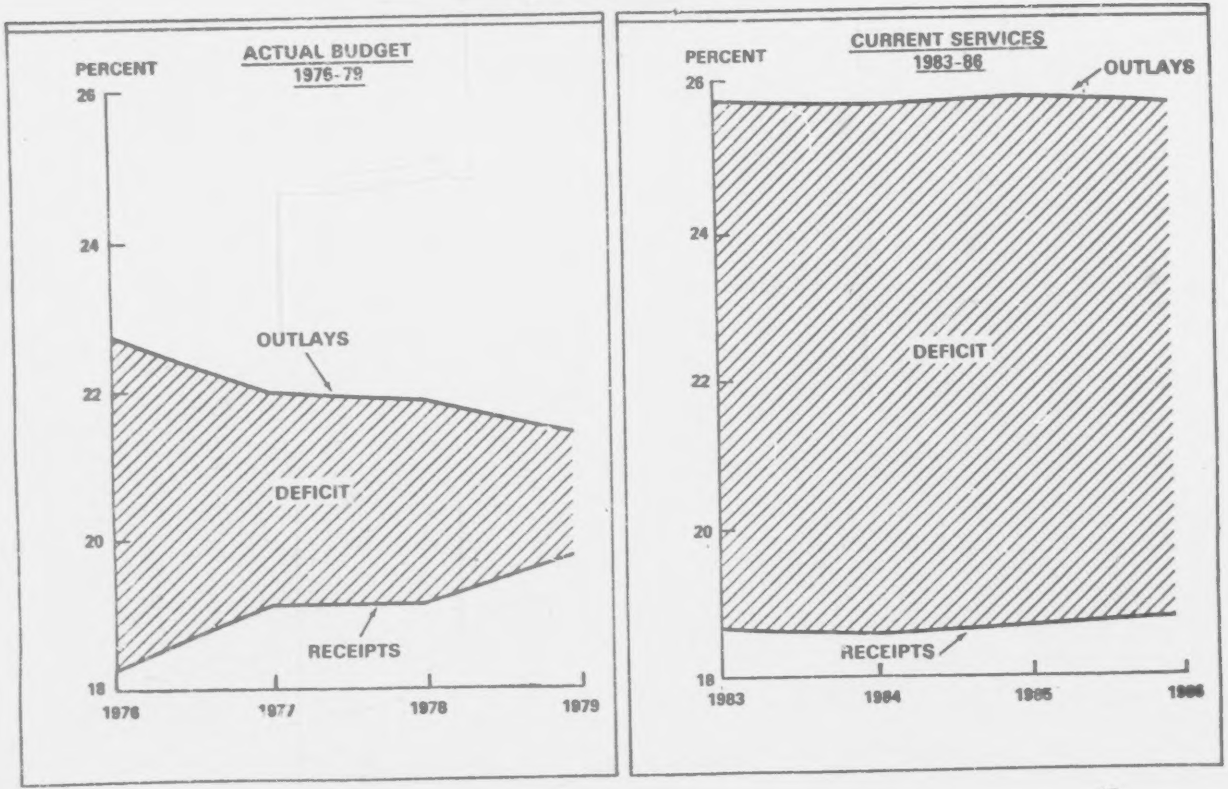


GROWTH IN REAL GNP	1984	1985	1986	1987	1988
1% LOWER	262	294	326	367	396
ADMINISTRATION FORECAST	248	267	284	308	315
1% HIGHER	[illegible]	241	242	247	232

ADMINISTRATION FORECAST VS 1960'S

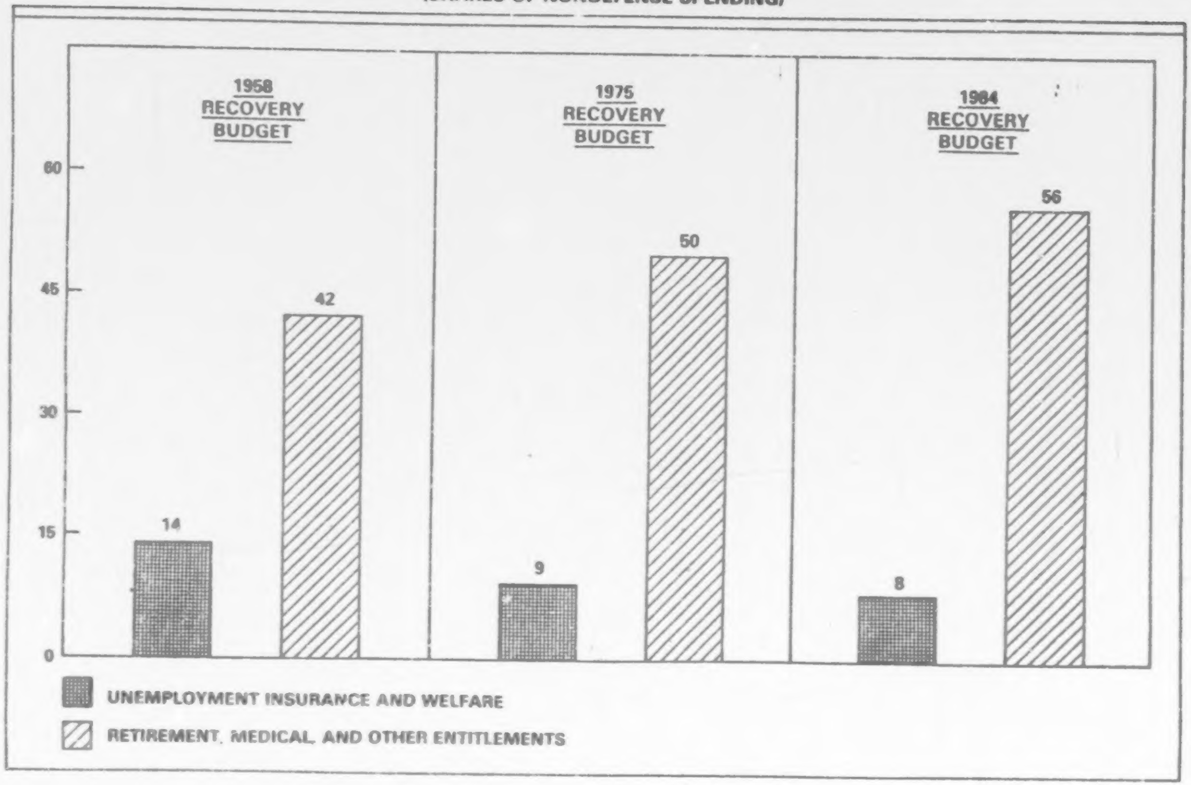


CHANGE IN BUDGET RESPONSE TO RECOVERY
1976–79 VS 1983–86
(SHARES OF GNP)

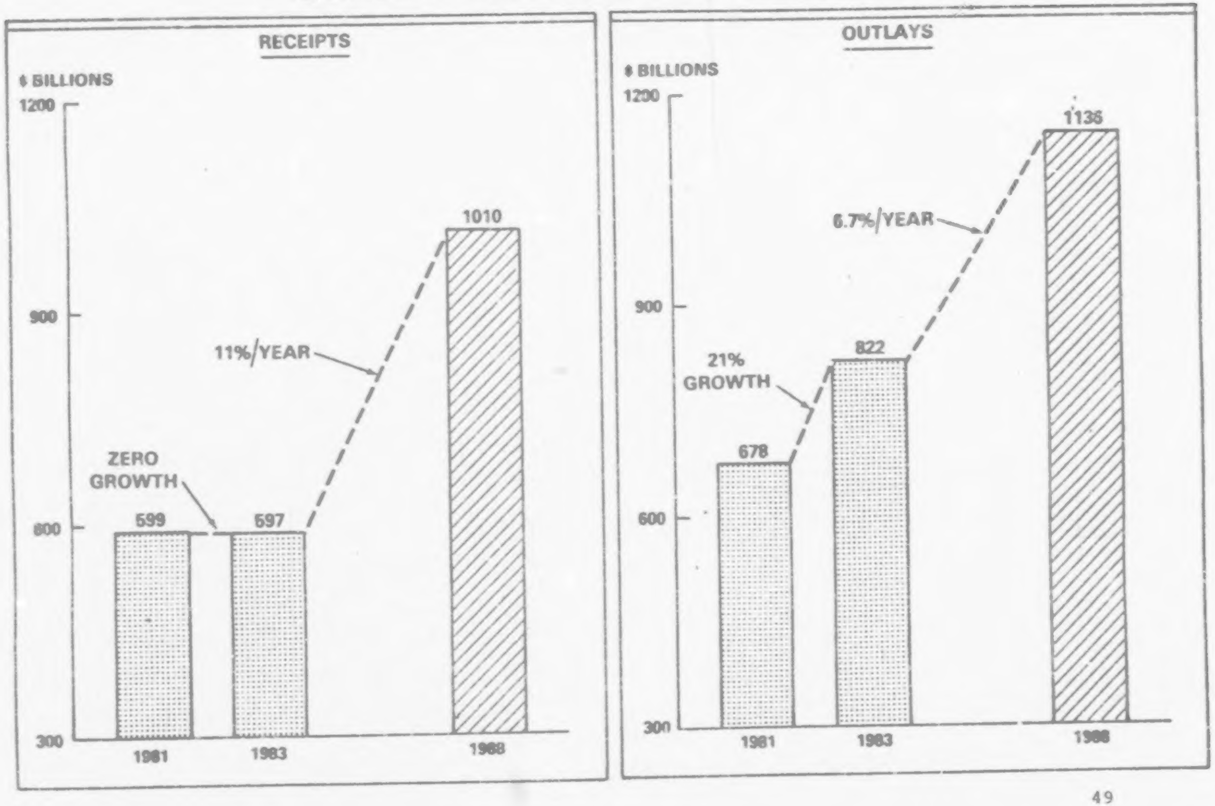


REDUCED SENSITIVITY OF BUDGET OUTLAYS TO ECONOMIC RECOVERY

(SHARES OF NONDEFENSE SPENDING)



IMPACT OF 1981–83 REVENUE STANDSTILL ON OUT-YEAR BUDGET TRENDS



Senator **Jepsen**. Thank you.

Mr. Stockman, what percent of our gross national product does agriculture contribute to our economy?

Mr. **Stockman**. What percent agriculture contributes?

Senator **Jepsen**. Yes.

Mr. **Stockman**. Well, I guess it would depend on how broadly you defined it, but if you included all of the transportation, the processing, and marketing, and so forth, it's a large sector of the economy, although I'm not sure of the precise percent.

Senator **Jepsen**. Well, it's up there. What does it contribute to our balance of payments in our trading?

Mr. **Stockman**. Well, the last time I checked, I think we exported 44 billion dollars' worth of farm commodities in 1981, and that was nearly one-fifth of our total exports.

Senator **Jepsen**. OK. Now then, I noticed that the administration's fiscal year 1984 budget requests a 21-percent reduction in the Department of Agriculture's program levels from $71.9 billion to $67.1 billion. Of this $14.8 billion cut, over 60 percent, or $9 billion, is taken from the international affairs and commodities program. Included in this $9 billion reduction is a reduction of $1.8 billion in the export credit loan guarantees which is a 38-percent cut under the fiscal year 1983 level.

Considering that, would you say that this is consistent in the agriculture area with the President's pledge to farmers during his state of the Union message to assure a fair shake—and I'm familiar with that term, I've recommended it over the years because all farmers ask for is a fair shake in the world marketplace. Would you comment on that?

Mr. **Stockman**. I'd be happy to, Mr. Chairman. I'd ask you to turn to the chart on page 20 because I think we can put this into perspective.

The reason that it appears the budget for the Department of Agriculture is going down is that in 1983, we had a massive explosion of outlays for CCC as a result of target deficiency payments and crops being brought under loan. We would spend about $19 billion this year, an historic record, much more than what's ever been spent before in real terms.

Now, without our PIK program and without the target price freeze, that would automatically decline by $6 billion in 1984 under the current farm program because the projections are that prices are strengthening somewhat and that, as a result of that, outlays will fall automatically, not as a result of taking away any money or cutting any budget, just the automatic decline from this abnormal peak of nearly $19 billion in outlays in 1983.

But, of course, we're proposing to go beyond that and try to get the agriculture sector back into balance with a combination of the PIK program and a freeze on the target prices that are automatically escalated under current law. If we do that, it's another $3 billion saving. But most of that reduction comes from the automatic decline in CCC outlays under current law. This accounts for most of the reduction in the budget for agriculture.

Any of the other discretionary programs are near last year's levels. Funds for agricultural research and for some of the other discretionary programs in the agriculture budget pretty well wash out, although there are some reductions.

Now in terms of the agricultural credit, the CCC guaranteed loans, I believe we've asked for $3 billion which is the same level we asked for last year, and that has proved to be more than adequate in the past. But an emergency occurred early or in the middle of last year in which we decided temporarily to increase the level to $4.8 billion in order to accommodate the big loan guarantee that was made to Mexico as part of the bailout package and part of the effort to help them solve their balance-of-payment crisis. So we don't expect that to happen again. We certainly hope it doesn't happen, and, therefore, the level is flat. Other than this special one-time emergency that occurred, we haven't cut it or raised it. We've kept it at about $3 billion.

Now beyond that, Congress mandated some direct budget outlays for export credit and we've instituted the SWAT program and that will mobilize somewhere in the range of 2 billion dollars' worth of credit to move U.S. farm commodities in the international market and we are prepared to do that again if conditions indicate it's required.

So I think if you look at these numbers fairly, there is no special discrimination against agriculture or no unfair treatment. It's just this big drop in CCC outlays that causes the numbers to come down. Over the 3 years, 1982, 1983, and 1984, even with the PIK program, we're going to spend over $40 billion in farm price supports and deficiency payments, an enormous amount and far beyond anything ever done before. I think that's pretty good support for the agricultural sector, given the kind of circumstances we're in today.

Senator **Jepsen**. The Chair would advise the committee members that we'll be on an 8-minute rule because of the number of people we have here today. I have a couple more questions.

If gross national product rises 1 percent, how does that affect the deficit?

Mr. **Stockman**. One percent higher real GNP growth beginning this year will reduce the 1984 deficit by about $14 billion. For each year that 1 percent higher real growth is maintained—1 percent, 1 percent, 1 percent—there would be a larger reduction. So, if we had 1 percent higher real growth from January 1983 through 1988, the deficit would be reduced by about $87 billion from what we have projected in that year, 1988. So, 1 percent for each year saves an average of $17 billion.

Senator **Jepsen**. Now by the same token, if we have a 1-percent decrease in unemployment, what does that add to the revenues or what does that take from the deficit?

Mr. **Stockman**. I would have to check that. It builds over time, but basically it's in the range of $20 billion.

Senator **Jepsen**. The figure most commonly used is $25 to $27 billion.

Mr. **Stockman**. Well, in the early years it's around $20 billion, but then it builds up to about $30 billion. It runs $16 billion the first year and $31 the sixth year. I think we have that in the budget.

Senator **Jepsen**. All right. Then one more question. How does a 1-percent drop in interest rates affect the budget?

Mr. **Stockman**. Well, the first year it would be about $2 billion; the second year, $7 billion; the third year $10 billion; and it keeps building, but you have to have that sustained. In other words, not just a one-time change but a permanent 1-percent change.

The reason that the number grows is that as more and more of the debt portfolio turns over and is borrowed at the lower rate, the total savings begin to grow.

Senator **Jepsen.** In the budget message it says that if the recovery of real gross national product over the next 2 fiscal years is about 1 percent above our projections the deficit estimates would improve by an average of about $20 billion a year. You said $14 billion the first year and 28 the second and——

Mr. **Stockman.** We said in the budget message 1 percent over the next 2 fiscal years. That's about six quarters and that is 1½ percent higher GNP level at the end of that period and that would be about $20 billion, halfway between $14 billion for 1 percent and $28 billion for 2 percent.

Senator **Jepsen.** Well, thank you, Director. I think we would be well advised to emphasize how sensitive these projected deficits we're reading about are to just a little tweaking. A 1-percent difference in unemployment is not very much in the way of percentages, but when you're looking at a 3-year period, it's many billions of dollars. Moreover, interest rates have dropped how many points?

Mr. **Stockman.** For 91-day Treasury bills, about 300 basis points since last July, 3 points.

Senator **Jepsen.** Given the sensitivity of the budget to business conditions, perhaps the fiscal situation could improve with better than projected economic recovery.

Mr. **Stockman.** Well, Mr. Chairman, I agree with that, but I must also point out that these rules work both ways. If you get 1 percent lower real growth for one reason or another, the deficit is that much bigger. If the interest rate backs up 1 percent higher, the deficit is that much bigger. And you have to ask yourself what is a reasonable trend or expectation or probability over time.

And for the sixth year period, 1983 through 1988, we project 4 percent annual real growth, which is the historic average for all postwar recoveries and is a good benchmark to use, recognizing that it could be higher or it could be lower. That's the historic average and we have a chart in the book that shows that, and I think that's a pretty good one to base our projection on for the outyears. This year, who knows? It could be much higher or it could start later than we would like, but for the longer term, a 4-percent projection over 6 years is a pretty good benchmark for measuring the size of this problem.

Senator **Jepsen.** Congresswoman Holt.

Representative **Holt.** Thank you, Mr. Chairman.

Mr. Director, you certainly explained the 14-year trend in defense spending as I've always seen it and understood it. I heard Mrs. Rivlin say in testimony before the Armed Services Committee that about 7 percent of GNP was our defense figure. She said that was not historically high nor was it inflationary because of our excess capacity in our industrial base. Do you agree with that?

Mr. **Stockman.** Yes; I agree with that. In fact, it's even more—the contrast is even clearer. For most of the postwar periods we've spent 8 to 9 percent of GNP. In 1981, we were down to 5 percent or 5.5 percent. At the present time, we're not much over 6, and if the full proposed buildup goes forward we would be around 7.5 percent by 1988. And in one of the back sections of this presentation here we have tried to put that in perspective so you can see it was a share of GNP. As a matter of fact, it's on page 7 and if you would look at that you can see that even by 1988 defense outlays as a share of GNP are well below most of the period from 1955 to the early 1970's.

Representative HOLT. Very good. Well, if you remember, I struggled on the Budget Committee to get some recognition of our off-budget items and our Federal credit activities.

Is the administration doing anything to try to contain that tremendous explosion? I think certainly that's a large part of our problem.

Mr. STOCKMAN. Yes, we're working on that. There are two parts of it. One is the off-budget spending, the outlays. I think they peaked at a historic level of $21 billion in 1981 and with this budget we'll have off-budget outlays down to about $8 billion or so by 1988. So I would consider that pretty dramatic progress, but it requires some help on reducing the level of lending for the rural electric program, Farmers Home Administration program and a lot of others.

Representative HOLT. Oh, well, that's different.

Mr. STOCKMAN. That's where your off-budget spending is.

Representative HOLT. I understand.

Mr. STOCKMAN. Now the other part of it is loan guarantees and we believe that those are still far too large but housing is a very major element of that and we don't want to disrupt the housing recovery underway right now, so we are projecting about $100 billion I think in off-budget loan guarantees in 1984.

Representative HOLT. How do our projected deficits as a percentage of GNP compare to other industrialized countries? I get this argument every time I mention the size of the deficit of Japan and Germany and they've been able to keep inflation under control. Realistically, the size of the deficit in comparison to GNP, is that a reason in Japan for their——

Mr. STOCKMAN. I think the more important comparison is the size of this deficit relative to net private savings. The reason that the Japanese can have larger deficits, even though there they're beginning to have trouble now, is that they have a much higher national savings rate to fund the Government borrowing. We have one of the lowest savings rates among industrialized nations and therefore can tolerate, over time, much lower deficits.

Representative HOLT. How much do you think our tax reductions will provide? What kind of incentives will that provide for savings? Will we be able to expand the pool of savings through that?

Mr. STOCKMAN. Well, I think we've seen evidence that that's happening already. The savings rate over 1982 was about 6.5 percent, well above where it was in 1980 and early 1981, about 5 percent.

Representative HOLT. Now in the Post this morning there was an Associated Press statement that the Reagan administration has settled on a 5-percent surcharge on personal and corporate income taxes as part of a standby tax package proposed in the President's new budget. The administration has rejected an alternative plan for a 1-percent surcharge on taxable income because this would be a burden on low-income taxpayers. How does that switch affect the tax revenues and the deficits in 1986 to 1988?

Mr. STOCKMAN. Well, actually, the standby that we have proposed was described as equivalent to a surcharge of 1 percent on taxable income. There are a lot of different ways to impose that to get the same dollar amount, $46 billion and $49 billion and $51 billion in 1986 through 1988; and at a later date we've indicated we will propose the precise mechanism. I think the story is based more on internal consideration and not on final recommendation.

Representative HOLT. We've had a lot of discussion in here with Mr. Volcker and with Secretary Regan about the monetary policy of the Fed, trying to get them to inform us how much influence the administration has tried to have or how much it wants to have on monetary policy.

Do you feel that, first, the monetary policy is appropriate? Do you make any recommendations to the Fed? Do you feel that—well, Mr. Volcker said that the administration, he feels, approves of the monetary policy. Is that a true statement?

Mr. STOCKMAN. Yes, that's an accurate statement and basically we believe that current policy is appropriate, that it is helping to further the recovery without at the same time taking us back down the track of reinflation that will undo all the progress that we've made over the last 2 years at very great cost.

I think the problem now is fiscal. The problem now is to get the Government's financial house in order and find ways to close these deficits. The financial markets fear that if these huge triple-digit deficits continue, sooner or later the Federal Reserve will be pressured into running the printing presses in overdrive to pay for them, that is to monetize them, and we'll be back to the race with double-digit inflation. Nobody is going to lend for 5-year projects or 10-year money for a new factory if they think the inflation rate is going to be back up to the double-digit range. So the most important thing we can do for jobs, investment, and economic growth is to get those deficits down and help to abate that lingering fear in the financial markets.

Representative HOLT. Thank you, Senator.

Senator MATTINGLY [presiding]. Congressman Scheuer.

Representative SCHEUER. Thank you very much, Senator.

Mr. Director, as a former colleague, we are delighted to have you here.

I'd like to ask you a question about two structural problems in our economy that we've got to address if we're ever going to find our way out of this mire of perennial deficits.

The first structural problem is the problem of a couple million kids who have little hope of being employed, many of them after 12 years of school don't have job skills, don't have literacy skills, can't read an instruction manual, have never been regularly employed and don't know what it's like to be employed. They flow in a nether world of welfare and unemployment insurance and various kinds of licit and illicit activities. This is getting to be a cancer in our society, this new under group of young people who are unemployed, out of work, out of school, out of hope. And it's becoming a growing problem in our society that I think we're concerned with on both sides of this table.

I'd like to know what you have in mind in terms of how our society is going to cope with this problem and hopefully cut this generational chain of poverty, unemployment, alienation, bitterness, and ultimately despair.

The second structural problem I think we've got to address, and I hope you're thinking about it, is our health service delivery system which isn't a health system; it's a sickness system based on tertiary hospital beds at $350 or $400 a day. We're relying on a cat scan or open heart surgery when we should be relying on diet and exercise and avoidance of tobacco and alcohol and violent situations that are killing us.

Do we have any plans to get away from this extraordinarily wasteful and futile sickness care system and get into a preventive health care system—and I believe this has got to be President Reagan's own thinking. All the cat scans and open heart surgery in the world are not going to improve our health unless we get concerned with our own health through control of diet, through exercise, through avoidance of tobacco, alcohol, and especially avoidance of violent situations. And I won't go into the safety belt question that could have saved us $4 or $5 billion a year had you and I been able to achieve a consensus a couple of years ago.

These are two structural problems and I'd like to know how you intend to address them.

Mr. STOCKMAN. Well, I think you have identified two of the more intractable structural problems that we have. Let me try to respond to the youth unemployment question.

I think, first, we have to recognize we have certainly tried a lot of different approaches over the last 15 years. There isn't too much evidence that they have been successful, except in the limited case of the Job Corps where we seem to get fairly good results; but it's very expensive on a per case basis.

However, I think there are a number of things that we could do, although I don't know whether you will agree with them or not. It seems to me, first, there is clearly a barrier to entry into the labor force, stemming from the current minimum wage law, for 17- and 18- and 19-years-olds in terms of unskilled jobs, learning work habits and showing up and staying through the day, producing. Whatever you think about the minimum wage for adults or for the mainstream of the economy, it seems to me that if we had a special minimum, which we are proposing in this budget, very limited in scope, for those first-time entrants into the labor force, we might expand the number of jobs available.

The only way you can really learn the work discipline and habit is by doing it. There's no Federal training program that will teach you how to get there at 8 o'clock. So that's one thing to do.

Second, we passed and restructured our training program in a major way last year. That was a bipartisan effort. I think we're going to have a substantially strengthened job skill and training program that's targeted on youth; 85 percent of this money is targeted on the low income and especially the low income under 20 years old. We can argue about the funding level, but I think we've got a delivery mechanism now that's better than we ever had before.

Third, it seems to me that ultimately we have to have an expanding economy. For the last 4 years——

Representative SCHEUER. These kids aren't helped by an expanding economy.

Mr. **Stockman**. Well, I wouldn't agree with that entirely. An expanding economy alone will not solve that problem, but without an expanding economy that problem will be totally intractable. For the last 4 years we've had no growth in this economy. First, we had too much inflation and then we had too much disinflation all at once, but hopefully we are now on a path where things are stabilizing, the imbalances have been worked out, the inflation has been curbed, and if we do the right things now we can keep on an expanding track. That has to help as well.

It seems to me those three things—overall the new economic policy, the new training program and the right level of resources, and an entry level minimum wage—I would point to.

On the health care side, that——

Representative **Scheuer**. Just one last question before you leave the structural unemployment problem. You said—and absolutely rightly so—that the Job Corps is expensive. I think it costs $12,000 or $13,000 a year which is more or less the cost of sending a kid to Harvard, but those kids weren't ready to go to Harvard. Have you ever considered on a cost-benefit basis the cost of not sending them on the Job Corps, having them out there frustrated, out of work, out of hope, alienated, and hungry, and maybe a good many of them bumping their heads up against the criminal justice system, becoming clients of our juvenile crime system? What are the costs of the alternative for getting them into the Job Corps?

Mr. **Stockman**. Obviously that's something to look at.

Representative **Scheuer**. And a lifetime on welfare and public housing?

Mr. **Stockman**. That is something to look at, but again, you can always make too much of every good thing. Now the evidence I've seen suggests to me the Job Corps works, but it might not work for everybody and there might be some self-selection. Those who are motivated to leave their home, their community and go 200 miles away may work for it because they're motivated. Those who stay behind and become delinquents may not be helped by the Job Corps at all. So there are a lot of different things we have to do.

On health care, that is a terribly complicated subject. I don't know how much we want to get into it today, but what we are suggesting with the measures that we have in the budget package and the health reform plan I think point in the right direction.

In the prospective reimbursement plan for hospitals, we are essentially saying pay on a case basis; whatever the diagnosis, pay a flat amount for each diagnostic related groping [DRG]. That would put enormous pressure on the hospitals to use the right testing and not ones that aren't needed, the right course of treatment and the right length of stay because you're going to be paid no more whether you have 65 tests or 20, whether the stay is 25 days or 15 days or whether you use exotic cat scans or something simpler and cheaper. I think that basic reimbursement mechanism, starting with medicare and seeing that generalized throughout the third party reimbursement system, would be one major change in that direction.

But, Congressman, I would suggest also that if this is a sickness care system as you described it, as long as we keep encouraging people to buy first dollar coverage for sickness care with the tax law, we're not going to see the system out there change or people's behavior change very easily as well. So the tax cap, which is designed to encourage lesser dollar coverage and more cost sensitivity and awareness on the part of the consumer is also essential to moving in these broader directions that you're talking about.

Representative Scheuer. I thank the Director and I thank the Senator.

Senator Mattingly. Congressman Snowe.

Representative Snowe. Thank you, Senator.

David, you offered a defense of the defense expenditures and for a moment I'd like to go beyond the arguments of whether an increase of defense expenditures are meritorious at this time or whether an imbalance between social service spending or defense spending does exist in the present budget that has been offered by the President. But beyond that and beyond those arguments, isn't the rate of increase in the defense spending exacting too high a price from the economy given the fact that we are probably cutting social service programs to the bare bones, given the fact of the conditions of our present economy? Isn't the rate of defense expenditures too great at this time, even if all the proposed justifications for the weapons programs and other categories in the Defense Department are justified? Isn't it just too high a price, given the threat of the deficits? It's still largely based on the President's budget recommendations for 1984, 1985, and 1986. They are considerable. In fact, in 1985, it's $194 billion.

So I'm just wondering why the administration wouldn't consider deferrals of expenditures, deferral of programs, until we get this economy under control, and just do the things that are absolutely necessary within the Pentagon and defer the other expenditures.

Mr. Stockman. Well, I would say a couple of things on that. No. 1, defense spending is no different than any other spending in terms of its economic impact, and our problem is aggregate spending and our difficulty is choosing where to curtail it. We've done a lot of that already and it becomes more and more difficult over time. But I hear some people talking about cutting defense by $10 billion and then doing a $10 billion emergency jobs program. Well, what does that accomplish? If you move $10 billion from things that you need for the long run into make-work jobs or local public works that you don't necessarily need, you've accomplished nothing except to undermine the defense program. You haven't helped the deficit and you obviously haven't helped the economy by moving it from one category to another.

So, yes, we have a problem with recovery and the size of these deficits, but we are suggesting that there are other things to do besides seriously jeopardizing the defense investments we need.

Representative Snowe. Well, when I look at the rate of growth in defense spending and also the fact, as you mentioned, the domestic areas, yes, there is no question that we had to impose a rein on Government spending in many of the programs that we now have, but I just wish the administration would apply the same structural reforms to the defense programs with the same zeal as it has with many social service programs. I think we could probably find a lot of areas in the Defense Department that could be curtailed because of the waste and fraud and abuse that exists. But nevertheless, going beyond that, this deficit has got to be brought down—we've got the social service area and some of the recommendations for the defense reductions, but beyond that, what can the Congress do if we wanted to go beyond that and reduce these deficits even further? What choice do we have?

Mr. STOCKMAN. Well, I think that is a good question but I would just urge that at least get done what we've recommended here. We have to do something on the COLA and pay freeze. There is no doubt about it. We have to do something on the big medical and retirement programs. There is no doubt about it. If we can get all of that done, get the standby revenue mechanism in place and further things that are reasonable and that a consensus will support, that will be fine. But if we don't get the first things done we're going to have deficits that will positively choke off the recovery. There's a $558 billion package of things to do in this budget over 5 years and I would urge that before we start adding let's see if we can get these done in this way or some other way.

Representative SNOWE. But the budget doesn't seem to be allaying the fears of the financial markets at this point.

Mr. STOCKMAN. Well, it's a paper document at this point.

Representative SNOWE. That's right.

Mr. STOCKMAN. I think that the financial markets know that a paper document will not stop the Treasury from borrowing. They want to see enacted statutes.

Representative SNOWE. But we went beyond last year, reducing the size of the deficits beyond what the administration wanted, and I see these deficits for 1984 and 1985 which are overwhelming and we're boxed in. If we can't reduce defense any further, if we can't raise taxes, and I don't think it is an appropriate time to raise taxes, should we halt the third year of the tax cut or defer tax indexing? Down the road we have the standby taxes which I certainly don't support because it's imposing a $5 per barrel tax on oil which I think is just going to hurt certain regions of the country——

Mr. STOCKMAN. That's on both domestic and imports.

Representative SNOWE. But I think it would be passed on.

Mr. STOCKMAN. It would. It's not the same as the import fee, but it would hurt New England.

Representative SNOWE. It certainly would hurt our region considerably. The fact that oil has increased by 80 percent since 1977 obviously is going to create further hardship on those individuals who are least able to afford that. So I'm just sayng there's going to be some other solution. We are limited in Congress if we want to go beyond and reduce the size of deficits that the President has settled on. What other areas are there? We can't possibly cut social service programs any further beyond what the President has recommended, and even those are substantial.

Mr. STOCKMAN. Well, as I suggested to the Budget Committee this morning, there are no magic solutions. There are no easy exits or steps that will solve the problem. We are going to have to have a mix of things and we believe this is the right mix, that we probably can't get much further than this without jeopardizing some things that are very important—the recovery of defense, the recovery of the economy, and some decent level of taxation for the long-term future.

Representative SNOWE. What percentage of the deficit do you consider to be structural?

Mr. STOCKMAN. Well, in the current year a good part of the deficit is due to the sheer recession conditions that we're in. By 1988, in my view, it's all structural. In other words, under our economic forecast, we're roughly at full employment in 1988 and the deficit is $315 billion on the baseline—that is without policy change—and that's nearly all structural. That's the built-in imbalance by 1988 between spending and revenues.

Representative SNOWE. What is the cost of unemployment for each percentage point to the Treasury at this time for 1984? Is it any different than 1983?

Mr. STOCKMAN. No. If you reduce the unemployment rate by 1 percent, you would save about $16 billion the first year and $29 billion by the fifth year out if you sustained a 1-percent lower path.

Representative SNOWE. On another area, regarding medicare, you are recommending cost sharing payments for the elderly and the fact is the budget is already recommending reduction to the elderly by 19 percent. Can you explain what this cost sharing will do and what impact it will have on the elderly in this country?

Mr. STOCKMAN. Yes; let me try to go through that because I think there's been some distortion of what we're proposing. The current structure of cost sharing for hospital care under medicare is irrational because it says that after the first day where you pay a deductible there's absolutely no copayment from the second through the 60th day. But if you're very ill and you have an extended hospitalization, you pay 25 percent from day 60 to day 90, 50 percent from day 90 to 150, and beyond that you pay 1 percent. So the sicker you are, the more you pay; the better off you are and the shorter the stay, you pay nothing at all.

What we're proposing is to shift that structure entirely so that after 6 days people pay nothing by way of out-of-pocket copayment, but for the 2d to the 15th day of routine stay they pay an 8-percent copayment, and for days 16 through 60 they pay a 5-percent copayment.

Now with the money generated there, we can pay for catastrophic protection after 60 days so there's no copayment at all and still reduce the overall cost of medicare slightly by about 2 percent a year.

Now, in addition to that, we're calling for a change in part B premium, but that would not really take serious effect until 1986, 1987, and 1988.

So what does all that mean? Let me give you one example. Under current law, if you were in a hospital for 15 days covered by medicare part A and B and had routine surgery and physician visit followups each day, it would cost you $1,000 out of pocket under current law—physician copayment, physician deductible.

Under what we're proposing for 15 days it would cost you $1,500 for the same illness and the same course of treatment. So that's an increase. But if you're in 90 days with an extended illness under the current system it would cost you $4,900 in physician deductible, hospital deductible, copayments after the 60 days, and so forth.

Under what we're proposing, that would be reduced to $3,200 over that 90-day stay.

Now if you have a truly catastrophic illness and you're in the hospital nearly half a year—and there are several hundred thousand of those cases a year under medicare—and that's what bankrupts people once and for all—under the current system you would pay $18,000 in out-of-pocket medical and hospital bills under medicare. Under what we're proposing you would pay $4,000, a drastic reduction for the out-of-pocket cost of that catastrophic illness.

So you can see that for a lot of people it's a little more for a routine stay, but that would discourage excessive hospital use and excessive lengths of stay. For a small number of very ill people—and those people change every year—it's not the same person every year who has catastrophic illness—the elderly have a good statistical probability having one during their retired years—the cost is reduced enormously because once you get beyond 60 days, it's not really a matter of judgment any more whether you're there 2 days longer or indeed whether you're there at all.

The other thing we're doing in this package is reducing skilled nursing copayment after day 25, so there is a reduction in the existing copayment for skilled nursing care and it's designed to encourage people to go to skilled nursing rather than hospitals for extended stays, whereas today there's actually a perverse incentive to stay in the hospital after day 60.

So that's the whole package and it does have an impact but I think it all fits together in a way that's fair under catastrophic protection and there's an effect in terms of trying to reduce the average length of stay.

Representative SNOWE. Thank you.

Senator MATTINGLY. Thank you. This won't last long. First, I'd just like to say that for the last 2 years I have supported most of the things that have come out from this administration. I think I ranked No. 4 in the Senate as far as supporting the initiatives of the administration, and I think that's about the only reliable thing you can go on, what you did in the past, and what I did do is history. What I'm going to do in the future is probably unknown, which is comparable to the budget process. And I feel like what we have tried to do jointly, the reforms we have tried to make in the last 2 years, have been too slow to try to really insure that we have a sound monetary policy or a sound fiscal policy or try to insure that we're going to have a sustained permanent type recovery in the future.

What I would like to talk about is really just outlays in the budget. I mean, probably about the most firm thing you've got in there is the $805 billion that we think we're going to spend in fiscal year 1983. I think historically we can look at the year's out from 1984 with $848 billion and you know the figures as well as I do—there are probably going to be a few unreliable figures as far as outlays, knowing this Congress, as you and I well know this Congress, with the problem on the low side, which leads me to believe that the budget is out of control.

I think your comment that I read the other day that this budget was a starting point—I agree with you. What is being proposed is a starting point. We can talk about structural problems or whatever the problems are, but we're not going to solve those problems until such time—whether we're talking about debt or whatever we're talking about in this country—until you make these reforms in the entire areas of Defense and HUD and all the other agencies.

Just dealing with the aggregate—and I don't want to deal with specific parts of the budget but just the aggregate total, to me the proposal that was put forth is a proposal that is not what I would term fair and equitable. I think when you freeze COLA's for 6 months and you freeze pay for 12 months, that's not what I call an across the board, fair way, and as you probably know, I'm supporting an across the board freeze, that except for the national debt and the medicare or social security program, to me that is the only way that I can see we can force the reforms or force the change—that's by an across the board freeze. I just want to know—you made the comment that that budget was a beginning, as we both well know. Would you consider supporting an across-the-board freeze at this time?

Mr. **Stockman**. Well, Senator, I would suggest this is about as close to an across-the-board freeze as you can get. As a practical matter, we will spend $501 billion in 1983—that's what we project—and there's $500 billion for nondefense programs in this budget for 1984 right now. I don't know how you can get much closer.

Senator **Mattingly**. Well, closer would be if you're going to restrain part of it for 6 months and part of it for 12 months, but you restrain all for the same amount. That way you don't end up with the unfairness issue which everybody has been faced with.

Mr. **Stockman**. Well, I think fairness is in the eye of the beholder, but the National Commission on Social Security Reform worked out a compromise that everyone from the President to the Speaker felt was fair under the circumstances, and that was a 6-month freeze.

Representative **Snowe**. That was prior to the President's budget or state of the Union message.

Mr. **Stockman**. But it was not totally unrelated. Now if you're freezing social security for 6 months, how can you freeze SSI for a year? The people on SSI are far worse off than the average social security recipient. Or how can you freeze veterans' pension for a year when most of the pensioners have income of less than $5,500 a year?

Now we are freezing Federal pay for a year. Why not? Federal pay goes to people who are active members of the labor force and have much higher incomes and can absorb that for a year because they do have savings and they're not entirely dependent on a pay raise this year. A lot of private sector employees have had pay frozen for a year.

Sure, we'd like to have everything symmetrical, but given the agreement on social security, which is central, I think we can justify a year for the people that we employ and a half year for those who depend entirely or nearly entirely on checks that they either have earned or that they deserve as a result of a means test.

Representative **Snowe**. I would think coming down the road that we will be faced with these inequitable types of legislation. That's a realism. That's a reality and it's coming. I'm not saying that I'm wedded in concrete. I don't think anybody is. But I think that the budget, in order to get it under control, we're going to spend in outlays $43 billion more projected in 1984 than 1983.

Mr. **Stockman**. That's entirely due to defense and interest.

Representative **Snowe**. But when you freeze HUD or when you freeze Defense or when you freeze whoever, what you do in fact is what you have been trying to do and what I have been trying to do is force reforms, force the Congress to make reform, and it forces agencies to make reform. You and I well know we can put the best Republican or Democrat as a head of any agency in this town and the tail wags the dog because they're such monstrous agencies.

Mr. STOCKMAN. Yes, I agree with that, but only partially. I think in more cases than not if you freeze a budget of an agency they will send you a "Washington monument," that is, claim they must close down their most popular programs. You can't simply freeze dollars and expect fundamental change to take place. You have to subscribe to reform. By a Washington monument, I mean all kinds of horror stories that would boomerang so fast that you'd remove the freeze and put in some money even beyond where you started. It's just not that simple. We have to look at these programs one at a time and determine the painstaking, difficult reforms that we have to specify.

Senator MATTINGLY. Well, I thank the OMB Director, and the committee will stand in recess.

[Whereupon, at 3:35 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 3, 1983.]

[The following information was subsequently supplied for the record:]

RESPONSE OF HON. DAVID A. STOCKMAN TO ADDITIONAL WRITTEN QUESTIONS POSED BY SEVERAL MEMBERS OF THE COMMITTEE

Question 1. Assume for a moment that Congress will continue to reauthorize and fully appropriate funds for the Economic Development Administration as it has in the past. Will the Administration maintain its insistence that EDA be terminated, or will it comply with the wishes of Congress?

Answer. The Administration maintains its position that EDA programs be closed out and has proposed termination of EDA as soon as possible in 1983. No program funds have been requested in 1984.

Because the Administration's budget has only recently been submitted, we do not think it is appropriate to assume that its proposal to close out EDA will not be considered. We believe when the Congress considers the proposal on its merits, it will find that EDA programs have been ineffective and do not create net new jobs nationwide.

Of course, if the Congress continues to reauthorize and fully appropriate funds for EDA, the Administration will comply with the law. Any changes that the Administration might propose in what the Congress appropriates will be reported to the Congress as required by the Impoundment Control Act.

Question 2. Why does the administration, in this period of near 11 percent unemployment, feel compelled to attempt to terminate an agency which creates cost effective, permanent jobs?

Answer. The Administration proposes to terminate EDA because economic expansion and job creation will be simulated more effectively through the President's overall economic recovery program, which includes general tax, spending, and regulatory measures. In fact, there is no evidence that EDA programs have created new jobs nationwide. Rather, such programs appear to encourage potential growth in some areas at the expense of other areas. Even then, funds appropriated for EDA programs have not created any jobs for over a year.

States and their localities will continue to receive Federal assistance for economic development through block grant programs that distribute Federal funds more efficiently and provide for more local discretion.

Question 3. What is the Administration's rationale behind seeking legislation to require copayment on all services covered by medicaid, including services such as prenatal care where the problem is usually seeking too little care rather than too much?

Answer. Copayments at the level proposed by the Administration—$1.00 per visit for welfare recipients and $1.50 for others—are not high enough to deter anyone from seeking needed care. Rather, they are designed to make beneficiaries stop and think before using medical services unnecessarily.

Question 4. Since we have required States to charge copayments for some services covered by medicaid, has it proved more costly to hospitals and doctors to collect these nominal copayments, than the copayments are actually worth?

Answer. States are not currently required to charge copayments for any services. Copayments are primarily designed to encourage only necessary use of services; they are not considered revenue measures. The carefully controlled RAND experiment, for example, showed an overall decrease in health care costs of 20 percent given copayments. Clearly this level of cost reduction far outweighs any administrative costs associated with copayment collection.

Question 5. Do you personally feel we have moved away from the philosophy that health care is a right each American is entitled to? If we can no longer afford this, who, in your opinion, should make the decisions on who receives what type of care—the hospitals, Congress, the budget director?

Answer. We believe that our health care cost control proposals will not "ration" health care. Rather, these proposals were designed to reduce the excessive, wasteful increase in health care costs that drives up resource consumption in this sector far beyond the level necessary to ensure that every American gets the needed health care. As in most areas with mixed public/private financing, the total amount of resources devoted to this area will be determined by a complex of individual decisions, market forces, and congressional and Executive actions.

Question 6. The Budget proposes to eliminate the WIN (work incentives) program since a mandatory workfare program will make it unnecessary. How will a mandatory workfare program encompass the goals of offering training and support services to AFDC recipients that had been offered under WIN?

Answer. The Administration believes that actual participation in job settings designed and operated at the local level is the most important component of the work strategy for AFDC recipients. Through these jobs, recipients will receive important work experience and training, which can be transferred to private sector employment. At the same time, communities will obtain useful public services.

We believe this "hands on" work experience will be more useful than what is currently funded under WIN. A recent GAO report (HRD 82-55; June 21, 1982) concluded that participation in WIN had no statistically significant effect on the employment status of AFDC recipients.

Improving training services will continue to be available to AFDC recipients under the Job Training Partnership Act (JTPA). This Act requires that AFDC recipients shall be provided with the training services offered under JTPA on an equitable basis taking into account their proportion of economically disadvantaged persons in the local population.

Support services will continue to be available in community work experience programs. Transportation costs and job-related expenses incurred by States and localities will be shared with the Federal Government. Child care needs will be met in a variety of ways—including the CWEP programs themselves.

Question 7. How can the Administration justify the proposed elimination of the Women's Educational Equity Act program, a small but very effective program, and the only one of its type, directed at achieving educational equity for women?

Answer. The budget contains several new initiatives to help ensure legal and economic equity for women, most notable among which are the following:

Social security benefit expansions, at a 7-year cost of $0.5 billion would provide that:

- Divorced spouses could receive benefits even if their insured former spouses chose not to retire;
- Widowed divorced spouses would not lose their benefits upon remarriage; and
- Benefits for disabled widow(er)s between the ages of 50 and 60 would be raised to the levels now provided to disabled widow(er)s 60 years old and older.

The child support enforcement program, under which the Federal Government provides funds for State and local administrative expenses incurred in establishing paternity and in collecting support payments from legally liable absent parents, would be significantly reformed to improve State and local operations. As a condition of receiving Federal support, States would be required to have in place laws and procedures that facilitate collections, and they would receive financial incentives for increasing collections. These financial incentives would take into account collections on behalf of all parents with children in their care, not just AFDC applicants, and would immeasurably increase financial security for women, especially those who are single parents.

WEEA is one of a large number of small Federal categorical project grant programs in the Education Department. Regardless of the relative merit of individual projects funded by these programs, as a group they represent a lower-priority use of scarce Federal resources than, for example, compensatory education programs. Given limited resources and such programs' narrow purposes, small scale, and lower priority, the Administration has proposed phase out by 1984. It should be noted, however, that the vast majority of projects supported by WEEA can be funded by States under the education block grant enacted last year (ECIA, Chapter 2).

Question 8. How is the Administration planning to strengthen enforcement of child support enforcement laws? Can we expect to see an extension of this to all women, and not just those on AFDC?

Answer. The Administration is proposing reform of the child support enforcement (CSE) program as part of the FY84 budget. The cornerstone of the reform is a restructuring of Federal matching payments for CSE activities.

Currently, marginal State performance is both tolerated and rewarded by a complicated and illogical Federal payment system. For example, States need only collect $.48 for each $1.00 in administrative costs to "break even" from their perspective. Nineteen States collect less from absent parents in AFDC cases than they spend on CSE administrative costs. Our proposal would repeal the current financing arrangements and replace them with a system that would encourage and reward increased collections and improved cost effectiveness. We believe this program will significantly improve the financial security of women in single-parent families, and strengthen parental responsibility.

Both AFDC cases and non-AFDC cases will be covered under this proposal. The primary focus, however, will continue to be on those cases who would otherwise have to resort to public assistance.

Question 9. How does the Administration justify cuts in child nutrition programs (specifically including the child care food program in a block grant at 85% of the current funding) at a time when the President has pledged to encourage the expension of child care?

Answer. The Administration has no intention of backing away from its commitment to the well-being of children. The nutrition assistance provided to child care facilities will subsidize 530 million meals in 1983. The present child care feeding program is, however, unnecessarily burdensome to States and child care operators. Its multi-layered reimbursement structure, mass of Federal regulations, and rigid requirements hamstring efficient administration. The proposed consolidation of child care feeding into the general nutrition assistance grant will permit States greater flexibility in providing assistance more efficiently to child care facilities where they find the need greatest. States could design programs targeted to their particular child care needs and avoid the unnecessary and costly complexities of the Federal program. Other components of the Administration's overall support for child care will also be maintained and even increased, such as Head Start and the Title XX social services program.

Question 10. The Budget proposes a new program of grants to States to help dislocated workers—those unemployed who are unlikely to return to their previous jobs or occupations. In my opinion, displaced homemakers are the quintessential dislocated workers. How can aid to displaced homemakers be incorporated into this program? And more generally, are there special provisions in the President's job training proposals to ensure that women's special employment needs are addressed?

Answer. The new program of grants to States to help dislocated workers is authorized under title III of the Job Training Partnership Act (JTPA). The intent of this title of JTPA is to assist experienced workers who find their jobs terminated or skills outmoded due to plant closings, technological developments, or other structural causes. Title III was deliberately drafted and narrowly targeted to help experienced workers or local communities that have been or are expected to be affected by major shifts in demand or other events outside their control which cause plants to close, workers to lose jobs, and tax bases to erode. Resources for this program are primarily allocated to States by a formula based on unemployment. States intentionally are given a great deal of flexibility to use these resources to meet their particular needs. It would be inconsistent with the intent of the legislation to mandate through regulations that a portion of title III resources be used for displaced homemakers.

There are other alternatives for assisting displaced homemakers under the JTPA as well as through other federally-financed programs. Under JTPA, Governors are required by section 121 to develop annually a coordination and special services plan presenting goals and objectives for job training and placement within the State and outlining the criteria for coordinating with programs and services provided by other State and local agencies such as vocational education, public assistance agencies, and the employment service. In addition the plan may also include programs and services for individuals whom the Governor decides require special assistance; displaced homemakers would qualify to be included in this category. In addition, section 203 of the JTPA allows up to 10 percent of participants in a service delivery area under the block grant program to be individuals who are not economically disadvantaged and specifically cites displaced homemakers as a prime example of the eligible population. This provision recognizes that the problems they face cut across all income levels. In addition, JTPA provides in sections 451 and 453 that resources may be used to assist displaced homemakers either through national programs that are administered on a multistate basis, or through assistance to pilot projects intended to eliminate artificial barriers to employment faced by these women.

Question 11. How does the Administration justify the proposed elimination of the Senior Community Service Employment program as a separate program? Surely few programs have received a greater outpouring of support in Congress than this one, and the rationale behind its proposed elimination is a bit hard to understand.

Answer. The Administration is not proposing to eliminate assistance for the part time employment of older Americans. The authority for such assistance, which provides part-time subsidized jobs for older individuals, will continue under a consolidated grant program for services to older Americans. The proposal would broaden the range of services now provided by the Department of Health and Human Services through the Administration on Aging under title III of the Older Americans Act to include subsidized part-time employment for low-income elderly persons. This would enable the current programs, which were previously financed separately, to be continued. Transitional provisions for the national contractors providing services under SCSEP would be included in the proposal. Because the Older Americans Act has several different administrative structures, this proposal would enhance coordination among programs (over half the SCSEP subsidized workers already provide services to the elderly) and reduce federal overhead. As Congressman Biaggi noted last fall when he introduced legislation to consolidate the administrative structure of the Older Americans Act, in an era of severe fiscal limits it is important to insure that we get the most mileage out of the Federal dollar. The proposal to broaden title III authority to include subsidized part-time jobs and thereby reduce overhead will be a step in that direction.

Question 12. Given that the entire increase in the deficit projected for 1983 and 1984—as well as for the years beyond—is due to the revenue reduction resulting from the 1981 tax cut, how can you argue that the structural deficit is due to the spending decisions made by previous administrations?

Answer. As Part 3 of the 1984 Budget explains, the structural deficit is the product of a decade of economic trends and policy decisions, particularly those that expanded the social contract and underfunded national defense.

As for the tax cuts, page 4–4 of the 1984 Budget shows that tax changes enacted in the last 2 years have reduced 1983 receipts by $63.5 billion, compared to a total deficit of $225 billion currently projected for that year.

President Carter's proposed 1984 budget would have fared no better, because it was based on far too optimistic an economic forecast. Indeed, that budget's published receipts estimate of $922 billion is higher than the January 1983 projection by more than $260 billion.

Question 13. Have you been able to make any progress in determining the true total for such (i.e., consultant) services?

Answer. Yes. Early in the Administration we noted the difference between the Fiscal Year 1981 consulting and related services data provided by the agency budget offices and the data reported to the Federal Procurement Data System (FPDS) by the agency procurement offices. In an effort to determine the reasons for the differences and reduce future reporting differences, we convened a meeting with representatives from the budget and procurement offices of the major agencies. The meeting revealed that much of the variance can be attributed to the inherently different reporting structures and times of reporting of the budgeting and procurement data.

The FPDS is a contract award data system which produces historical data. Procurement personnel enter into the FPDS the total amounts that may be obligated for the scope of the contracts. Entries into the system are coded in accordance with the major function of the contract requirement, i.e., studies and analyses, management studies, consultants, etc. Entries are processed before contract performance. On the other hand, the budget staff report past year data after the contract is concluded and according to legal requirements on the timing of the recording of obligations. As a result, the two figures answer two different questions:

> The FPDS data answers the question: What contracts were awarded, i.e., the total potential obligations?
>
> The actual year budget data answers the questions: What happened to the contracts that were awarded, i.e., the total including any downward adjustments?

The difference in the amounts reported reflects the fact that program changes and funding constraints can and do affect what actually occurs. For example, a three-year contract for $1,000,000 will be coded in the FPDS as a $1,000,000 award, but actual obligations for the year may be less than the $1,000,000 originally reported to FPDS in normal times, and even more so during periods of budgetary restraint. In summary, the budget and procurement personnel report the data pertinent to their operation at different times with different reporting instructions. Under the circumstances, most cases would result in the data not being identical.

We would like to point out that the one-time report that we sent to the Congress on March 30, 1982 was redundant, but probably necessary until we cleared up this problem. The Congress now has access to both types of data. The procurement data is available through the FPDS and the budget data is available under 31 U.S.C. 1114. This law already requires the agency heads to provide information on consulting services in their annual justifications to the Committees on Appropriations.

Question 14. Can the problem be remedied by requiring a new object classification listing for consultant services?

Answer. Since there is no longer a "problem" there is no need for a solution. As I pointed out earlier the Congress now has two sources of information, each capable of providing reasonably accurate estimates of what they are designed to measure. Adding an additional object class to the object classification structure will be redundant, it will not provide new information but it would be somewhat costly to accomplish, since each Federal activity would be required to modify its object classification accounting system.

Question 15. Did the agencies comply with the Appropriation Committee's directive to submit specific consultant services budget requests with their FY83 justifications?

Answer. We have no reason to believe that the agencies did not comply with those requirements or the legal requirements that we mentioned earlier, although the Committees on Appropriations would, of course, know for certain.

Question 16. Last January (1982), you proposed regulations that would have refined the definition of consultant and related services. Is a revised definition now in effect? If so, has it accomplished its intended purpose?

Answer. The revision to OMB Circular No. A–120 "Guidelines for the Use of Consultant Services" has been redrafted, but has not yet been reissued. A proposed bulletin on related services was determined to be unnecessary. A model control system for consultant and related services (attached) has been issued by OMB for use by the agencies to address problems in this area. Pilot programs have been implemented at VA and Commerce and other agencies are using the model. We are now considering the use of OMB Circular A–123 on Internal Controls to control abuse of the use of consultants rather than a separate OMB Circular A–120 dealing only with consultant services. No revised definitions of consultant or related services are needed if, when data is requested or submitted, its source and parameters are defined. For example, the Federal Procurement Data System should be used for contract awards and OPM's data files should be used for experts and consultants hired under personnel procedures.

JAN 1 5 1982

Model Control System
for
Consulting and Related Services

I. Introduction

This document provides a suggested approach to designing control systems for consulting and related services contracts. The document:

- Provides background pertaining to consulting and related services.
- Describes the objectives and features of a model control system.
- Defines and describes a model control system for consulting and related services contracts.

II. Definitions

A. Consulting Services. The official definition of consulting services is provided in OMB Circular No. A-120, "Guidelines for Consulting Services." Generally, they are services of a purely advisory nature that provide views and opinions on problems or questions concerning agency operations. Consulting services contracts may be used, when essential to the mission of the agency, to:

- Obtain specialized opinions or professional or technical advice which does not exist or is not available within the agency or another agency.
- Obtain outside points of view to avoid excessively limited judgments on critical issues.
- Obtain advice regarding developments in industry, university, or foundation research.
- Obtain the opinion of noted experts whose national or international prestige can contribute to the success of important projects.

B. Related Services. Related services are all procurement actions classified in the Federal Procurement Data System (FPDS) as:

- management and professional services (codes R401 through R499 in the FPDS);
- special studies and analyses (codes R501 through R599 in the FPDS); or
- management and support services for research and development activities, (codes R401 through R499 and R501 through R599 funded with research and development funds).

III. Background

A. Policy for Consulting Services. OMB Circular A-120 provides the basic Executive Branch policy concerning consulting services:

- Consulting services will not be used in performing work of a policy/decision making or managerial nature which is the direct responsibility of agency officials.
- Consulting services will normally be obtained only on an intermittent or temporary basis; repeated or extended arrangements are not to be entered into except under extraordinary circumstances.
- Consulting services will not be used to bypass or undermine personnel ceilings, pay limitations, or competitive employment procedures.
- Former Government employees per se will not be given preference in consulting services arrangements.
- Consulting services will not be used under any circumstances to specifically aid in influencing or enacting legislation.
- Grants and cooperative agreements will not be used as legal instruments for consulting services arrangements.

B. Consulting Services Abuses. Although Federal agencies have many legitimate needs for consulting services, Congressional hearings, GAO reports, and newspaper articles have described many abuses in their use. Most of the attention has focused on consulting services acquired through contracts (rather than personnel appointments or appointments to advisory committees). The abuses which have been identified include:

- Use of consultants to perform work of a policy making or managerial nature that should be carried out by agency officials or employees.
- Use of sole source contracts which precluded competition.
- A rush of "year-end spending" on questionable consulting services contracts.
- Consulting services which have no useful impact on agency operations, either because the requirements were not well defined or there were no agency procedures to monitor the contractor's work and follow-up on the results.
- "Revolving door" abuses whereby former government employees were improperly favored for consulting services arrangements.
- Conflict of interest situations where consultants would profit from the recommendations they made.

On July 2, 1980, the Director of OMB issued a memorandum requiring departments and major independent agencies to establish improved control systems that would achieve the policy goals in Circular A-120 and eliminate the types of abuses described above. The memorandum set forth certain basic requirements, but did not prescribe a standard control system.

C. Related Services Abuses. Many of the management problems associated with consulting services are also prevalent in contracts for management and professional services, special studies and analyses, and management and support services for research and development activities. Accordingly, the Office of Federal Procurement Policy has proposed an extension of the management controls in OMB Circular A-120, and the July 2, 1980 memorandum to related services. While the proposal has not received final approval as of this date, the model presented herein has been made applicable to related services.

III. The Model Control System.

A. Objectives. The objective of this model control system is to aid agencies in establishing, improving, and evaluating their systems for the use of consulting and related services. Agencies need not and are not expected to adopt the model control system per se. Rather they should incorporate critical elements of the model into existing systems or use the model as a tool in the development of new systems. The main objective is that each agency system include the documents, processes, and controls needed to satisfy the policy and guidelines of OMB Circular No. A-120 and the July 2, 1980, memorandum.

B. Features. The model control system is a system of documentation, processes, and control objectives that, if implemented and followed, can ensure that consulting and related services are appropriate and necessary, are being used in a manner that satisfies program needs, contribute to the best uses of agency resources, and are in accordance with applicable laws and regulations.

The model control system is presented in flow chart and narrative formats. These are the basic elements in the system:

- Documents, which are depicted by the symbol, , and which represent forms and other media used to transmit information.

- Processes, which are depicted by the symbol, , and which represent activities in the decision-making flow that commit the Government to the next step in the cycle.

- Control points, which are represented by the symbol, , and which represent the points in the cycle at which a document error could exist and/or an inappropriate decision made, and therefore, a point at which one or more controls could be installed to fulfill the specified control objectives.

There are two types of document controls and two types of process controls described in this model.

Document Controls:

- Completeness controls assure that the document contains the desired/necessary information.

- Reliability controls assure that the information is reliable, pertinent, and timely.

Process Controls:

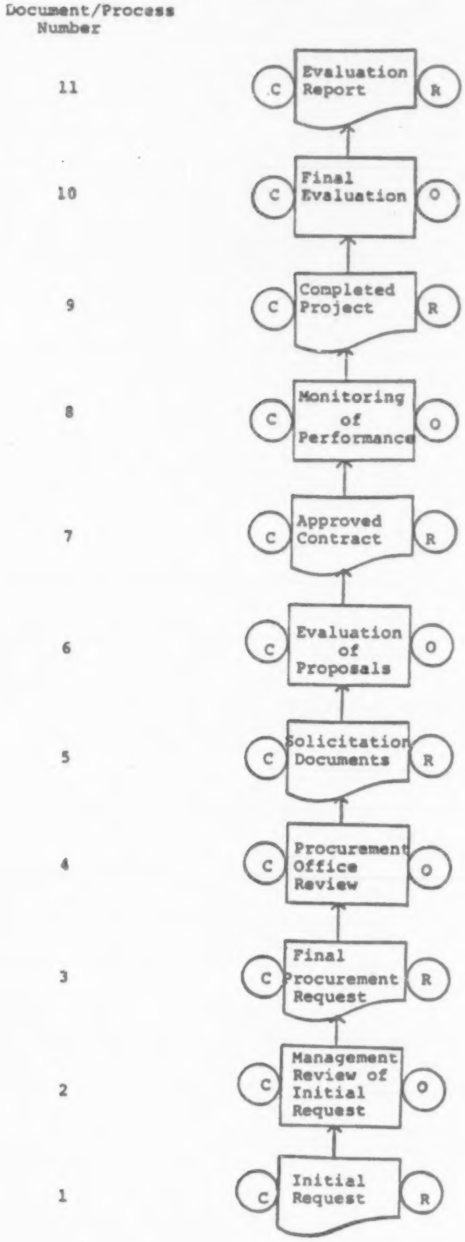
- Comprehensiveness controls assure that the process considers all aspects that are necessary for a decision that results in a proper expenditure of resources and that is in accordance with the Government's interests and objectives.

- Objectivity controls assure that the process is performed without bias. This can best be accomplished by a person or group whose interests are broader than the matter under consideration. Another way to obtain objectivity is to provide that duties be so segregated as to prevent the same person or group from both benefiting from and authorizing a consulting or related service.

The eleven documents/processes that make up the consulting and related services control system are presented as Attachment A. Control objectives for each document/process are presented in Attachments A-1 through A-11.

Attachment A

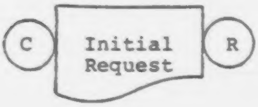
Model Control System for Consulting and Related Services


Document/Process Number
11
C
Evaluation Report
R
10
C
Final Evaluation
O
9
C
Completed Project
R
8
C
Monitoring of Performance
O
7
C
Approved Contract
R
6
C
Evaluation of Proposals
O
5
C
Solicitation Documents
R
4
C
Procurement Office Review
O
3
C
Final Procurement Request
R
2
C
Management Review of Initial Request
O
1
C
Initial Request
R

Attachment A-1

Document/Process Number 1

Initial Request



Description: This is the initial request for consulting or related services. It is typically prepared by the program manager that will use the service. The initial request is used to obtain management approval to proceed with the preparation of a detailed final procurement request and the necessary solicitation documents.

Completeness Control Objectives:

- Does the request define one of the following as the reason for seeking a service:
  - Obtain specialized opinions or professional or technical advice which does not exist or is not available within the agency or another agency?
  - Obtain outside points of view to avoid excessively limited judgements on critical issues?
  - Obtain advice regarding developments in industry, university, or foundation research?
  - Obtain the opinion of noted experts whose national or international prestige can contribute to the success of important projects?
  - Obtain assistance to complete a necessary project within a specified period of time?
- Does the request define one or more specific objectives for the service, and define the deliverables if appropriate?
- Does the request include sufficient documentation to demonstrate that the contract will not be used to bypass personnel ceilings?

Attachment A-1

- Does the request include a description of the relationship between the request and the agency's annual advance procurement plan?
- Does the request include documentation that the need cannot be satisfied by Government resources, or by previous consulting or related services reports?
- Does the request include a determination and justification regarding the use of a contract rather than one or more personnel appointments?
- Does the request identify the time frames during which the services must be provided?
- Does the request indicate if it is a result of an unsolicited proposal?

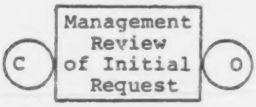
Reliability Control Objectives:

- Is the request prepared by a program office that is at an organizational level sufficient to assess program relevance and priority?

Attachment A-2

Document/Process Number 2

Management Review of Initial Request



Description: The Management Review of Initial Request is made to confirm that the objectives and approach for the proposed consulting or related services contract are proper and reasonable.

Comprehensiveness Control Objectives:

- Does the review consider the validity of the specified need for the services?
- Does the review determine that the services will not be used to perform work of a policy/decision making or managerial nature that is the direct responsibility of agency officials?
- Does the review confirm that the services are or will be temporary and that a repeated or extended arrangement has not been or will not be entered into except under extraordinary circumstances?
- Does the review confirm that the services will not be used to bypass or undermine personnel ceilings, pay limitations, or competitive employment procedures?
- Does the review consider whether the request is written to ensure maximum competition and that former Government employees will not be given preference?
- Does the review confirm that the services will not be used to aid in influencing or enacting legislation, including preparing testimony?

Attachment A-2

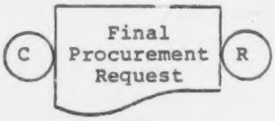
Objectivity Control Objectives:

- Are consulting and related services approved at a level above the organization initiating the proposal (two levels above for contracts in the fourth quarter)?
- Are special reviews (e.g., Procurement Review Board) used for sole source contracts and for high dollar value competitive contracts?
- Are requests for consulting services contracts above $50,000 approved by an Assistant Secretary or equivalent ($100,000, for related services contracts)?

Attachment A-3

Document/Process Number 3

Final Procurement Request



Description: The Final Procurement Request is prepared by program personnel following the review and approval of the initial request. Its purpose is to provide the contracting officer with all the information needed to proceed with the procurement of the consulting or related services.

Completeness Control Objectives:

- Does the final procurement request include all the information contained in the initial request?
- Does the final procurement request include a specific and complete work statement, including a specific period of desired performance?
- Does the final procurement request include a plan for monitoring the contractor's performance?
- Does the final procurement request include a plan for evaluating the completed product or services?

Reliability Control Objectives:

- Does the final procurement request include documentation of the necessary approvals of the initial request?
- Does the final procurement request include the approval of the head of the program office requesting the services?

Attachment A-4

Document/Process Number 4

Procurement Office Review

C
Procurement Office Review
O

Description: The Procurement Office Review is the review of the final procurement request conducted by the contracting officer in order to ensure compliance with required procurement policy and procedures. The preparation of the solicitation documents based on the final procurement request and technical assistance provided by the program personnel is included in this process.

Comprehensiveness Control Objectives:

- Does the contracting officer's review consider whether provisions of OMB Circular No. A-120 have been adhered to and that the documentation required by the circular is complete and included in the contract files?
- Does the contracting officer's review consider whether all other procurement rules and regulations have been satisfied?
- Are there procedures to assure that there is a fiscal officer's certification of the availability of funds?

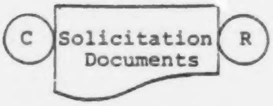
Objectivity Control Objectives:

- Are the responsibilities of the contracting officer defined such that his decisions are independent of those of the program officials?
- Are solicitation documents reviewed by other offices, such as General Counsel?

Attachment A-5

Document/Process Number 5

Solicitation Documents



Description: Solicitation Documents provide the information that contractors need to prepare complete proposals. They also present the criteria that will be used in evaluating proposals. The type of solicitation document used will depend on whether the procurement is accomplished by formal advertising or negotiation. Formal advertising uses invitations for bids (IFBs). Negotiated contracts use requests for proposals (RFPs). Most consulting and related services are acquired by negotiated contracts.

Completeness Control Objectives:

- Does the solicitation document include a description of the following:
  - Nature of the services required?
  - Time considerations and requirements for status reports, and for draft, interim, and final products?
  - Form of draft and interim, if any, and final products?
  - Evaluation criteria for ranking contractor proposals, and the weighting of cost, technical, and other factors? (For IFBs formal advertising rules would apply.)

- Does the solicitation document specify the information to be provided by the proposer, including:
    - Understanding of the work to be performed?
    - Proposed workplan?
    - Proposer's qualifications and experience for the project?
    - Key personnel to be involved in the project, including their qualifications and experience, and the identification of any former government employees who may have a conflict of interest?
    - Any proposed use of sub-contractors?
    - Any possible organizational or personal conflicts of interest?

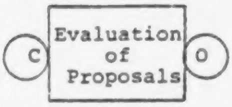
Reliability Control Objectives:

- Has the appropriate program office agreed to the solicitation's technical content?
- Has an authorized contracting officer approved the publicizing of the solicitation document?

Attachment A-6

Document/Process Number 6

Evaluation of Proposals



Description: The Evaluation of Proposals is the process of evaluating the responses to the solicitation document in order to award a contract.

Comprehensiveness Control Objectives:

- Are the special procedures of CFR 10 or 41 followed when the number of responses to a solicitation document is low?
- Are the proposals reviewed by the contracting officer, including:
    - A check of bidders against lists of ineligible, debarred, or suspended contractors, and against evaluations of previous performance?
    - A review of possible conflict of interest situations or use of former Government employees?
    - The implications of any proposed use of subcontractors?
    - Satisfaction of all conditions in the solicitation document and conformance with procurement rules and regulations?
- Has the contracting officer evaluated the cost proposals, including the reasonableness of the price in relation to the work to be performed?

Attachment A-6

- Has the appropriate technical review been conducted, including an evaluation of the:
    - Understanding of the work to be performed?
    - Clarity, comprehensiveness, and thoroughness of the work plan?
    - Technical qualifications and experience of the firm?
    - Qualifications of personnel to be assigned to the project?

Objectivity Control Objectives:

- Do the persons performing the technical evaluation have sufficient expertise and lack of bias?
- Has the evaluation been conducted in conformity with the evaluation criteria published in the solicitation document?
- Is the final selection reviewed at an organizational level above the office requesting the service?
- Does the contracting officer make a determination that the proposed award is fair and reasonable?

Attachment A-7

Document/Process Number 7

Approved Contract

C
Approved Contract
R

Description: The Approved Contract is the document which defines the services to be provided to the Government and the terms and conditions of the agreement.

Completeness Control Objectives:

- Does the approved contract clearly define the services to be provided, the deliverables, and the dates for progress reports, deliverables, and completion of the project?
- Are there procedures to assure that consulting services awards over $10,000 are identified for input to the Federal Procurement Data System?
- Are there procedures to assure that copies of consulting and related services contracts of $50,000 or more are forwarded to the agency's Inspector General (or equivalent official)?

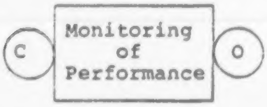
Reliability Control Objectives:

- Must the contract be approved by the program office requesting the service?
- Must the contract be approved by an authorized contracting officer?
- Must the contract be approved by other appropriate offices, such as General Counsel or a Procurement Review Board, as being consistent with the solicitation document?

Attachment A-8

Document/Process Number 8

Monitoring of Performance



Description: The Monitoring of Performance is the ongoing process of reviewing the services provided in relation to the terms of the contract. Responsibility for monitoring performance is shared between the contracting officer and the program office. The program office usually designates a "Contracting Officer's Representative" to carry out monitoring responsibilities.

Comprehensiveness Control Objectives:

- Are there adequate procedures to assure periodic assessment of work in progress, such as review of oral or written progress reports or completed tasks?
- Are payments related to completion of milestones as well as to expenditure of time?
- Are there adequate procedures to assure documentation and approval of all departures from the approved contract, e.g., changes in personnel assigned to the project, cost over-runs, changes in delivery and other milestone dates, and variations in content?
- Are there procedures, including notification of the Inspector General where appropriate, to address any irregularities in the performance of the contract?

Objectivity Control Objectives:

- Is monitoring conducted by both the contracting officer and program office, and are the responsibilities of each clearly defined?

Attachment A-9

Document/Process Number 9

Completed Project

C
Completed Project
R

Description: The Completed Project is the completion of the consulting or related services or delivery of a report to the requestor. It also encompasses a written statement of acceptance of the services as having met the terms of the contract, and authorizes final payment.

Completeness Control Objectives:

- Does the written statement of acceptance attest to the contractor's completion and delivery of all goods and services required in the contract?

- Is there a requirement for the resolution of any irregularities in the performance of the contract before final payment?

- Do all final reports containing recommendations to the agency submitted during the performance of a consulting or related services contract contain on the cover of the report the following information: (a) name and business address of the contractor; (b) contract number; (c) contract dollar amount; (d) whether the contract was competitively or non-competitively awarded; and (e) name of the sponsoring program individual in the agency and his/her office identification and location?

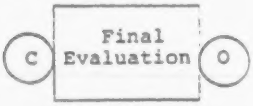
Reliability Control Objective:

- Is completion of the service or receipt of the product certified by the officials who requested the services?

Attachment A-10

Document/Process Number 10

Final Evaluation



Description: The Final Evaluation assesses a contractor's performance and the usefulness of the final service or product. It is different from the on-going monitoring conducted over the life of the contract in that it should encompass the totality of the services provided in relation to the requestor's requirements.

Comprehensiveness Control Objectives:

- Does the final review determine the extent to which the services met the specific needs of the organizational component requesting the study?
- Does the final evaluation determine the extent to which any recommendations and advice were implemented, and the reasons for not accepting any or all of the contractor's recommendations?
- Does the final evaluation determine (if feasible and timely) the impact of having implemented the contractor's recommendations?
- Does the evaluation compare actual costs against planned expenditures, including a review of the documentation and approval of departures from the contract?

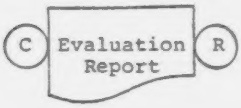
Objectivity Control Objectives:

- Is the evaluation conducted by both the contracting officer and the program office?

Attachment A-11

Document/Process Number 11

Evaluation Report



Description: The Evaluation Report is the assessment of the results of the project and the contractor's performance. It should be used by the requestor and other agencies in evaluating future proposals.

Completeness Control Objectives:

- Is the evaluation in writing?
- Is the evaluation forwarded to a central repository in the agency for easy access?
- Is the evaluation made available to other agencies?
- Is the Inspector General notified of any irregularity in the performance of the services?

Reliability Control Objectives:

- Is the evaluation report signed by the official requesting the services?
- Is the evaluation report signed by the contracting officer?

Question 17. Last year, in your report on administrative expenses, you said that OMB's Office of Federal Procurement Practices had asked a group of Federal agencies to review this issue and develop recommendations for improvements. The report stated that OMB would provide the appropriations committee with information resulting from any significant improvements resulting from this review. Did any improvements result? Were they reported to the committee?

Answer. A task group was formed to review and recommend improvements to the Federal Procurement Data System, R–400 and R–500 service codes. These codes are the service areas in which consultant services are most likely to occur. The attached revision has been implemented.

Apparently these changes were not reported to the committee.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OFFICE OF FEDERAL
PROCUREMENT POLICY

August 23, 1982

MEMORANDUM TO FPDS POLICY ADVISORY BOARD

FROM: Wm Maraist

Subject: Revision to the FPDS Service Codes R-400 and R-500.

As a result of the enclosed March 3, 1982 (Encl. 1) memo a task group was formed to review and recommend improvements to the FPDS R-400 and R-500 service codes. Agency members of the task group are shown on Enclosure 2.

The task group members have completed their review of the current FPDS R-400 and R-500 service codes compared to the needs of their respective agencies. Enclosure 3 represents the proposed new R-400 and R-500 codes as well as proposed new R-600 and R-700 codes which the group believes will adequately represent government-wide procurements in these categories.

Because of the press of time I am proposing that these codes be implemented by the Federal Procurement Data Center for the beginning of FY 1983 unless I receive objection from you as a representative of your agency before September 10, 1982. I trust that this short fuse will not be burdensome since the task group was broadly representative of the executive branch and had members from the major procuring agencies.

If you have any questions please call me on 395-3300.

Enclosures

cc: Task Group Members

Enclosure 1

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OFFICE OF FEDERAL
PROCUREMENT POLICY

MAR 2 1982

MEMORANDUM TO: FPDS Policy Advisory Board Members

FROM: William J. Maraist, Assistant Administrator for Regulations, OFPP

SUBJECT: Improvements to Product and Service Code Manual

A meeting was held in OMB on February 25, 1982, to discuss the variances between FY 81 consulting and related services procurement data provided by the budget offices to OMB and the FY 81 data reported to the Federal Procurement Data Center (FPDC). Representatives from the budget and procurement offices of DOD, DOE, NASA, DOI, HHS, NASA, AID, and the Department of Education were present. (See Enclosure 1.)

As a result of this meeting, it is considered essential that an interagency group be formed to define each R400 and R500 code in the FPDS Product and Service Code Manual. The group will also consider expanding the finite categories in these two series. It is intended that the interagency group will present its recommended changes to the FPDS Policy Advisory Board with the goal of making the changes effective October 1, 1982.

The first meeting of this interagency group is scheduled for March 18, 1982, at 10:00 a.m., in Room 10103 of the New Executive Office Building, 726 Jackson Place, N.W. The name of your agency's representative should be phoned to me (395-3300) prior to the meeting. If you have any questions, please give me a call.

Enclosure

Enclosure 2

FPDS Task Group

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OUSD R&E Acquisition Management
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Enclosure 3

Code	Title
	AUTOMATIC DATA PROCESSING SERVICES (R3)
R301	ADP Facility Management Services
R302	ADP Systems Development and Programing Services
R303	ADP Entry Services
R304	ADP Transmission Services
R305	ADP Teleprocessing Services
*R306	ADP System Analysis
**R307	Automated Information System Services
R399	Other ADP Services
	PROFESSIONAL SERVICES (R4)
R404	Land Surveys, Cadastral Services (non-construction)
R405	Operations Research Services
R406	Policy Review/Development Services
R407	Program Evaluation Services
R408	Program Management/Support Services
R409	Program Review/Development Services
R411	Real Property Appraisals Services
R412	Simulations
R413	Specifications Development Services
R414	Systems Engineering Services
R415	Technology Sharing/Utilization Services
R416	Care of Animals
**R418	Legal Services
**R419	Educational Services
**R420	Certifications & Accreditations
**R421	Technical Assistance
**R422	Telephone & Field Interview Services
**R423	Intelligence Services
**R424	Expert Witneses
**R425	Engineering Technical Services
**R426	Communications Services
R497	Personal Services
R498	Other Professional Services
	SPECIAL STUDIES AND ANALYSES (R5)
R502	Air Quality Analyses
R503	Archeological/Paleontological Studies
R504	Chemical/Biological Studies and Analyses
R505	Cost Benefit Analyses
R506	Data Analyses (other than scientific)
R507	Economic/Socio-Economic and Labor Studies
R509	Endangered Species Studies (Plant & Animal)
R510	Environmental Assessments
R511	Environmental Baseline Studies
R512	Environmental Impact Studies
R513	Feasibility Studies (non-construction)

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**New

Code	Title
R516	Animal & Fisheries Studies
R517	Geological Studies
R518	Geophysical Studies
R519	Geotechnical Studies
R520	Grazing/Range Use Studies
R521	Historical Studies
R522	Legal/Litigation Studies
R524	Mathematical/Statistical Analyses
R525	Natural Resource Studies
R526	Oceanological Studies
R527	Recreation Studies
R528	Regulatory Studies
R529	Scientific Data Studies
R530	Seismological Studies
R532	Soils Studies
R533	Water Quality Studies
R534	Wildlife Studies
R537	Medical & Health Studies
**R538	Intelligence Studies
**R539	Aeronautic/Space Studies
**R540	Building Technology Studies
**R541	Defense Studies
**R542	Educational Studies & Analyses
**R543	Energy Studies
**R544	Technology Studies
**R545	Housing & Community Development Studies
**R546	Security Studies (Physical & Personal)
**R547	Accounting/Financial Management Studies
**R548	Trade Issue Studies
**R549	Foreign Policy/National Security Policy Studies
**R550	Organization/Administrative/Personnel Studies
**R551	Mobilization/Preparedness Studies
**R552	Manpower Studies
**R553	Communications Studies
**R554	Acquisition Policy/Procedures Studies
R599	Other Special Studies and Analyses

ADMINISTRATIVE SUPPORT SERVICES (R6)

**R601	Material Management
**R602	Courier & Messenger Services
**R603	Transcription Services
**R604	Mailing & Distribtion Services
**R605	Library Services
**R606	Court Reporting Services
**R607	Word processing/Typing Service
**R608	Translation Service (including sign language)
**R609	Stenographic Services
R699	Other Administrative Support Services

*Relocated
**New

MANAGEMENT SUPPORT SERVICES (R7)

*R701	Advertising Services
*R702	Data Collection Services
*R703	Financial Services
*R704	Auditing Services
**R705	Debt Collection Services
**R706	Logistics Support Services
**R707	Contract, Procurement, and Acquisition Support Services
*R708	Public Relations Service
R799	Other Management Support Services

Move:
Audio/Visual Services to T016

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*Relocated
**New